RECOVERY OF NON PERFORMING ASSETS IN BANKS AND FINANCIAL INSTITUTIONS

A CRITICAL STUDY ON THE EXISTING LEGAL MACHANISM IN INDIA

THESIS SUBMITTED TO
BUNDELKHAND UNIVERSITY, JHANSI

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DOCTOR OF PHILOSOPHY.
BY
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UNDER THE GUIDEDANCE AND SUPERVISION OF

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May 2006

CERTIFICATE

This is to certify that the thesis entitled ***"Recovery of Non Performing Assets in Banks and Financial Institutions - A critical Study on the existing Legal Mechanism in India"*** submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy is a record of bonafide research carried out by ***Mr. Anil G. Variath*** **at the Institute of Economic and Finance, Budelkhand University, Jhansi** under my supervision for the manuscript is suitable for submission for the award of ***Doctor of Philosophy.***

This is to further certify that Mr. Anil G. Variath has put in the required attendance during this period.

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DECLARATION

I, **Anil G. Variath**. hereby declare that the thesis entitled **"Recovery of Non Performing Assets in Banks and Financial Institutions – A Critical Study on the existing Legal Mechanism in India"** is prepared by me under the guidance and supervision of **Dr. M.L.MAURYA;M.A.,PH.D., Head, Department of banking, Director, Institute of Economic & Finance Bundelkhand University, Jhansi** and work was carried out at **Institute of Economic & Finance, Bundelkhand University, Jhansi.**

This is submitted to the Bundelkhand University, Jhansi and Uttar Pradesh in partial fulfillment of the requirement for the award of the degree of **Doctor of Philosophy in ~~Law~~.** Economics

I further declare that the thesis or any part there of has not been previously submitted for the award of any degree or diplomas.

Place: Jhansi

Date: 29th May 2006

Anil G. Variath

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Place: Jhansi

Date: 27th May 2006

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PREFACE

The health of any economy is evident from the health of Banking Industry. The banking Industry is so much vibrant, that any minor development in the economy would reflect upon the banking. The health of banking is also very much essential for the stability of the economy. We can see for the stability of the economy. We can see from the history that the economic depression and crisis have also been characterized with the failure of the banks.

Banking was in vogue in India since time immemorial. The banking in India was mainly centered on the indigenous money lenders, who were all out to exploit the poor. The impact of Islamic rule has for some time changed the situation. The British rule has helped the banking to crystallize into institutions. With the establishment of Presidency Banks, the imperial banks and other joint stock banks the banking in India has entered into a new era. However, even now the lion share of India's rural masses are not free from the clutches of the local money lenders and indigenous bankers. The Reserve Bank of India as well as the Government of India are trying their level best to spread the net of banking to cover the rural lot to uphold the principles of social banking, we have a long way to go.

The banks in India, unlike its counterparts in other countries have to undertake the social cause also. The special schemes for the welfare of the formers weaker sections etc. have been taken up by the banks, without having any concern for its profitability. The new economic policy and consequent liberalization of economy have accelerated the pace of bank lending and the bank lending has increased many folds.

With the introduction of the prudential norms of income recognition, it was realized that many of the loans advanced by these banks had been proved to be unrecoverable and to be categorized as bad debts. The Banking Industry has realized that it is weighed down by enormous amounts of bad debts that threaten the very health of the system. The public sector banks are worst affected followed by old generation private sector banks.

The bad loan popularly known as the Non Performing Assets (NPAs) is a fairly high proportion of total loans. The recovery of the Non Performing Assets has been given thrust by the banks since nineties and it has found its results also. It is greatly on account of the shift from the conventional practice of litigation to the new methods of recovery. The new look at the problem of identifying and containing the NPA has provided an opportunity to have a critical evolution of the existing machinery of recovery and to realize that a significant portion of their funds are locked up is litigation. The effect is that not only the funds are locked up in unproductive assets, but also their value gets deteriorated with passage of time. An urgent need was felt to work out a suitable mechanism through which the dues could be realized without much delay. The Narasimham Committee has addressed all those issues and submitted its two reports. The first report of the committee itself laid emphasize upon establishing a separate forum to deal with the cases of recovery of dues towards Banks and Financial Institutions.

Whether the reforms that have changed the face of banking industry consequent to the recommendation of Narsimham committee could successfully serve the purpose of NPA recovery? Whether the two mechanism as envisaged under the Recovery of Debt due to Banks and Financial Institutions Act, 1993 and the Securitization Asset Reconstruction And Enforcement of Security Interest Act 2002 has been

capable of meeting the Industry aspirations? Is it possible to make use of the existing system in a better and effective way? These questions are to be examined critically. The preparation of this thesis is an earnest and humble attempt towards this direction within the limitation of the available data and my ability.

As a person who has been directly associated with the N.P.A. recovery in the capacity of an in house lawyer for banks as well as a practicing lawyer, I have special interest in this subject. The subject as such was always live in my mind. When I discussed the topic with my guide Dr.M.L.Maurya, he encouraged me and also suggested some improvements in my original approach towards the subject.

In the preparation of this thesis I have referred to many authorities' textbooks, journals websites, consulted eminent personalities in the field of Law, Banking and academic and also conducted a field survey. Many of my friends and well wishes have helped me in this endeavor. I am deeply indebted to each one of them. It is not possible to name each of them to express any gratitude. However, I cannot avoid mentioning the names of those who have significantly contributed to the success of this project.

My gratitude to my supervising guide Dr.M.L.Maurya, Head Department of Banking, Economics and Finance, Bundelkhand University is beyond words. He had been kind and generous enough to accept me as his student and to give guidance and direction. It is his constant persuasion which made this thesis a reality. In fact, he has been the source of inspiration for me to complete this doctoral research programme.

Dr.Sanjeev Chedda, Lecturer, Institute of Law, Budelkhand University is another important personality whom I owe a lot of thanks for the valuable assistance and persuasion given to me.

My wife, Dr. Bindu Variath who has also a former faculty in the Institute of law in this University deserve special mention for planting the idea of doing research in my mind and for all the pain taken to see that the idea materializes into a full fledged thesis.

My thanks are also due to Mr. Andrew Joseph, Legal Advisor, Reserve Bank of India, the Principal Prof. A. K Inamdar and staff of Siddhartha College of Law Mumbai, the librarians and staff of High Court Library, Bombay and to the institutions like Bankers Training College, Bombay, N.I.B.M., Pune and S.I.B.T.C., Bangalore the Catholic Syrian Bank, the Sangli Bank, Indian Institute of Law and the Colleagues of Law firm M/s. S.N.Gupta &Co, Mumbai, where I am presently working.

The officers of different banks who have responded positively to the field survey conducted by me also deserve special thanks. Mr.Santosh Nair and his team who provided the system assistance to me, my colleagues and team members Mr.Shivanraju, Ms.Jyoti Thakur, Ms.Vaishali Bhiungade, Mr.B.Rama Subramani and Ms. Savita.B.N also deserve special thanks for their various types of contributions and assistance done to this thesis.

I owe a lot to my family for the successful completion of my research work. My father Mr.G.K.Nair, mother Ms. Subhadra G.Nair, my wife Dr. Bindu Variath and my son Aaditya have co-operated with me and shared my burden in different ways at different levels; without which; I fear it would not have been a success.

I will be failing in my responsibility if I do not thank the Hon'ble Vice Chancellor, the Hon. Register and other Senior Executives of the Budelkhand University, Jhansi, for the sincere and dedicated leadership given to the academic development of the University its, research programme and for the endeavour to make it an institution of excellence.

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Anil G. Variath

INTRODUCTION

The Institution of Banking is in vogue in India from the ancient period onwards in one form or another. Banking was a part of our ancient village civilization and the village economy was very much depended up on the bankers. The bankers in the early stages were local money lenders and indigenous bankers. Their commercial and social outlook had undergone tremendous changes under different political setup which held the reign at the particular area at different times. The advent of Islam and the Mughal rule in India has made some significant changes in the structure of rural banking. However the credit of institutionalizing the banking Industry goes to the British rulers. It was under the British rule that the presidency banks were established and the concept of banking companies have evolved and developed.

Banking has influenced the economy to a great extent and also become popular even before the independence. In the post independence period the operation of banking has not only reached every walk of life of the people, but also started taking social responsibly too.

The role of banking has undergone major changes both in attitude and operation since independence. The abundance of social cause shouldered by them has no doubt weakened the health of the banks. Political reasons could be attributed to this situation. The situation just before the economic reforms and the formulation of new economic policy was alarming, if viewed from the point of banks healthy existences. The banks in India were by enlarging the business at one hand. On the other hand the fund deployed by them in loans and advances were locked up with the enormous amount of bad loans that posed a potential threat to their asset base.

'Asset' means the goods, property and other resources of an Individual or a corporate those are capable of meeting the financial obligation like payment of debts or liabilities. Assets can be tangible and in tangible and constitute source of wealth. In the banking parlance 'asset' means and includes cash in hand, cash reserve with the Reserve Bank of India money at call and short notice, investment in securities, bill purchase, furniture and fixtures, owned premises, loans and advances granted to customers. The major portion asset of the banks and financial Institution is constituted by the loans and advances to customers.

Assets generate income. The progress of the Banks and Financial Institutions depends on the income generated by these Assets. The asset which does not generate income is called as a Non-Performing Asset (NPAs). A loan asset will become NPA if the installment or interests remain unpaid. The Non-Performing Asset further classified into Sub-standard Assets, Doubtful Assets and Loss Assets.

The administration of resources and Financial Security of a nation is dependent on the strength on the banks. When the circulation of the money is blocked, it would adversary effect the health of banks and financial Institutions. The recoveries of loans are very much essential for redeployment of funds. When difficulties are experienced in recovering the assets, the banks must be in a position to enforce the security charged to them. Unfortunately in India we do not find an encouraging picture. Therefore, a comprehensive approach towards NPA has to be adopted. The problems of NPAs have to aspects one related to reduction of existing NPAs by way of recovery and other related to minimizing the future NPAs. The present study has covered both this aspects and it has also made an enquiry into various measures available for Recovering the NPA.

The first and foremost task should be to identify the causes of NPAs. The following major causes are identified during the course of the study by the researcher:-

01. Non viability of project
02. Poor project evolution by bankers or leaders
03. Delay in implementation and commencement of project
04. Delay in realizing loan installment
05. Misappropriation and misutilisation of funds
06. Diversion of funds by the units
07. Higher cost of borrowings
08. Changes of policy by Government
09. Unhealthy competition in the industry
10. Poor capital market conditions
11. Lack of follow up
12. Willful default
13. Delay in initiating recovery proceedings and legal action
14. Inadequacy of legal methods.

This thesis is prepared on the basis of secondary data available in the text books, Law reports and Directions given by RBI for settlement of NPAs from time to time and also on the basis on primary data collected on the basis of field survey; opinion of bankers layers etc. The researcher being a person directly associated with the Recovery of NPAs himself has certain insight into the subject and objective analysis is made on the prospects of Recovery on the basis of such insights. Based on the available material and data, research inferences have been drawn up and suggestion are made which the researcher thinks would be helpful to tackle the menace of NPAs at least to a comfortable extent.

The entire work has been divided into 9 chapters. The First Chapter is an attempt to trace the historical background of banking in India as well as in the International context and goes to evolution of Joint Stock Banks, the establishment of Reserve Bank of India, the development of social control of banks. This chapter also puts a bird's eye view on the development of Banking Law in India.

The Chapter II is an attempt to have an analysis of credit Management by Banks. The general principles of advance, different kinds of loans and special banking services are dealt with herein.

Securing a Credit Facility is very much important from the point of view of recovery. The various methods by which the banks would secure the credit facilities have been the subject matter of Chapter III.

Chapter IV deals with the Introduction of prudential Norms of asset classification and the income recognition. The effect of prudential norms on the profitability of banks and the commitment of the banks towards a better system of Asset Liability Management are also discussed. The prudential norms are introduced on the recommendation of Narsimham Committee. Therefore much weight age is given to the recommendations of the Narsimham Committee in this Chapter.

Chapter V deals with the recovery of NPAs through conventional methods of Civil Suit and new methods like the out of court settlement, Lok Adalat, one time settlement etc.

Chapter VI deals with recovery of Debt through The DRTs. The constitution, functions and the operational aspects of the Tribunals find place in this chapter.

Chapter VII is exclusively set out for the Recovery through Securitization. It is a critical appraisal of working of the SARFAESI Act of 2002.

Chapter VIII deals with the factors which contribute to the birth of NPAs both at the pre lending and a post lending stages and also suggests some preventive measures for arresting the growth of NPA in future.

Chapter IX is exclusively dealing with conclusion. It is the summing of the thesis on the basis of the research inferences that has been arrived at during the course of the research. The problem of NPAs can not be eliminated over night. However, it can be minimized and steps can be taken to see that further NPAs are not created in future. The NPAs can be recovered by the timely Legal action and with the Co-operation of the borrowers. This work would be a success if it can contribute at least a little in addressing the problem of NPAs and the suggesting some meaningful measures in arresting in growth as well as in getting it recovered effectively.

Anil. G.Variath

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CHAPTER – I

DEVELOPMENT OF BANKING IN INDIA

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➢ Evolution of Money Economy:

From time immemorial, the banker has been an indispensable pillar of Indian society and economic activity was confined to exchange of good as and when needed – the `Barter System'. The impracticability of barter system gave birth to the feeling in favor of common medium for Exchange of goods. The introduction of the division of labour, however, brought in its wake the use of money, without which there was a peculiar complexity and trouble in the matter of exchange. The medium of exchange was different like stones, wood, metals and ivory etc. Gradually value has been attached to such medium; and it got developed into what we call `money' today. Money economy, in its turn, could not do without the institution of banking for any considerable time.

There is plenty of evidence to show that India was not a stranger to the conception of banking. Loans and usury were well understood in the olden days itself. (Civilization in Ancient India by R.C.Dutt, revisited edition, Vol.I, p.39). Reference is often made to debt contracted at dicing, to pay off a debt was called Rnam Sam-m. Allusions are also made to debts contracted without intension of payment. This shows that the giving and taking of credit in one form or other must have existed as early as the Vedic period. However, the transition from money lending to banking must have occurred before Manu, who has devoted a special section to the subject of deposits and pledges, where he says, "A sensible man should deposit his money with a period of good family, of good conduct, well-acquainted with the law, various having many relatives wealthy and honorable (Arya)".[2] (The Laws of Manu by Buhler. The sacred Books of the East, (Vol.XXV, p, 286, 1866). He further gives us rules, which governed the policy of loans and rates of interest. Sir Richard Temple's testifies to the fact, that banking business was carried on in ancient India.[3] (Sir Richard Temple's lectures; Journal of the Institute of Bankers, Vol.2, 1881).

However, banking in those days must have meant largely money-lending, financings kings and their wars, through certain rudiments of modern banking functions were not unknown to the then bankers.

➢ Money Lending in Ancient Times:

The term 'Bank" literally means an establishment for storage or deposit money in an institution which borrowers money from and lends money to the public at large.[4] The word is said to have derived from the Italian word 'bancs' which itself was the Italian version of the German word 'banck' meaning a joint stock fund[5]

Origin of the word "Bank" – There is difference of opinion in this regard. According to some authorities, the word "Bank" itself is derived from the word "bancus" or "banque", that is, a bench. The early bankers, the Jews in Lombardy, transacted their business on benches in the market place. When banker failed his "banco" was broken up by the people, when the world "bankrupt". There are others, who are of the opinion that the world "bank" is originally derived from the German world "back" meaning a joint stock fund. But "whatever be the origin of the word 'bank', "as Professor Ramchandra Rao says (Present – day Banking in India, 1st edition, p.88)". It would trace the history of banking in Europe from the Middle Ages".[6]

➢ Early History of Banking:

As early as 2000 B. (C), the Babylonians had developed a banking system. There is evidence to show that the temples of Babylon were used as banks. But the spread of irreligion soon destroyed the public sense of security in depositing money and valuable in temples, and the priests were no longer acting as financial agents. The Romans did not organize State Banks as did the Greeks, but their minute regulations, as to the conduct of private banking, were calculated to create the almost confidence. Aristotle's dictum, that the charging of interest was unnatural and consequently immoral, was adhered to fanatically. Even now some Mohammedans, in obedience to the commands contained in that behalf in their religious books, refuse to accept interest on money loans. The followers of Aristotle's dictum forgot that the ancient world, the Hebrews had maintained money lenders and made no sine of interest, but only of usury.

➢ Impact of West:

However, upon the revival of civilization, growing necessity forced the issue in the middle of the 12th century, and banks were established at Venice and Genoa, though in fact they did not become banks as we understood them today. Again the origin of modern banking may be traced to the money dealers in Florence, who received money on deposit, and were lenders of money in the 14th century, and the names of the

Bardi, Acciajuoli, Perussi, Pitti and Medici soon became famous throughout Europe, as bankers.

In England, during the reign of Edware III, money changing – an important function of the bankers of those days–was taken up by a Royal Exchanger for the benefit of the Crown. He exchanged the various foreign coins, tendered to him by travelers and merchants entering the kingdom, into British money, and, on the other hand, supplied persons going out of the country with the foreign money they required.

The ground was prepared for modern banking in England, by the influx of gold from America and the simultaneous growth of foreign trade. Land ceased to be the only form of wealth, and the country gentlemen and the town merchants, began to hold part of their "capital" in cash. Impetus was given to public banking by the seizure, by Charles I in 1640, of £130,000 bullion left for safe custody by the city merchants at the Royal Mint. As a result of this Royal repudiation, the merchants began to entrust their cashiers with large sums, but the latter misappropriated their masters' money for their own benefit. Finding that their employees had not treated them better than their king, the city merchants decided to keep their cash with goldsmiths, who in those days had strong rooms and employed watchmen.

Thus, large sums of money were left with the goldsmiths for safe custody against their signed receipts, knows as 'goldsmiths' notes," embodying an undertaking to return the money to the depositor or to bearer on demand. Two developments quickly followed, which were the foundation of "issue" and "deposit" banking, respectively. The first was that the goldsmiths' note became payable to bearer, and so was transformed from a receipt to a bank note. It was payable on demand, and enjoyed considerable circulation. Gradually, the goldsmiths discovered that large sums of money were left in their keeping for long periods and, following the example of Dutch bankers, they thought it safe and profitable to lend out a part of their customers' money, provided such loans were re-paid within a fixed time. Further, realizing that the business of loaning of other people's money at interest was profitable, and in order to attract larger amounts, the more enterprising of the goldsmiths began to offer interest on money deposited with them, instead of charging a fees for their services in guarding their client's gold. This marks an important step in the development of banking in England. Business grew to such an extent that it soon became clear that a goldsmith could always spare a certain proportion of his cash for loans, regardless of the date at which his notes fell due. It equally became safe for him to make his notes payable at any time, so long as his credit remained good, he could calculate, on the law of average, the amount of gold he needed to meet the daily claims of his note-holders and depositors.

In 1672, English banking received a rude setback. Charles II borrowed heavily from the goldsmiths and, promptly like his father repudiated his debts. A crisis ensued, and was followed by a general suspension of payments. Confidence, however, was restored in spite of the shock and the general belief, which it produced among people that the goldsmiths were guilty of imprudence and exorbitant practices. It was soon after this date that the goldsmiths found that they could receive money on what is now termed "current account", i.e., money withdraws able without notice.

The Bank of England was started in 1694, largely as a result of the financial difficulties of William III, who was carrying on war with France. The public distrust of goldsmiths for the same was also responsible. One, Mr. Patterson, suggested a way out of the difficulties by offering to raise £1,200,000, which he was prepared to loan to the Government, if certain concessions, particularly the right to issue notes, were given to the proposed institutions. The Government agreed to the terms offered by Mr. Patterson, and an Act called the "Tonnage Act" was passed. The main provisions of the Act were as follows:

1. It authorized the raising of Pounds Sterling £1,200,000 by subscription, the subscribers forming a corporation to be called "the Governor and Company of the Bank of England".

2. No person could subscribe more than £10,000 before the first of July following, and even after that date, no one could subscribe more then £ 20,000 in total.

3. The Corporation was to lend the whole of its capital to the Government, and in return, it was to be paid interest at the rate of 8 per cent and £ 4,000 for expenses of management.

4. The Corporation was to have the privileges of a bank for twelve years, but the Government reserved the right of annulling the Charter after giving one year's notice to the Corporation.

5. The Corporation was forbidden to trade in any merchandise whatsoever, but was allowed to deal in bills of exchange, gold or silver bullion, and to sell any wares or merchandise upon which it had advanced money.

The new bank proved a formidable competitor to the comparatively small private banking firms, which had grown up from the London goldsmiths, and to the country-banks.

The year 1708 witnessed the passing of another important Act, which prohibited any other bank, with more than six partners, issuing promissory notes, i.e., bank notes. The most important clause of this banking legislation ran as follows:

> "That during the continuous of the said Corporation of the Governor and the Company of the Bank of England, it shall not be lawful for any body, politic or corporate, whatsoever created, or to be created other than the said Governor and Company of the Bank of England, or for other persons whatsoever united or to be united, in covenants or partnerships Exceeding the Number of Six persons, in that part of Great Britain called England, to borrow, owe or take up any sums of money on their bills or notes payable on demand, or at less time than six months from the borrowing thereof".

This Act, gave a monopoly of notes issue to the Bank of England, so far as joint Stock Banks were concerned, but left private banks, having not more than six partners free to issue notes. In London and the surrounding districts however, the notes of the private banks did not circulate to any appreciable extent; consequently these banks found the business of note issue unprofitable and gave it up; instead, they began to develop deposit banking. They received deposits, which were at first with drawable by letter, and later by cheques. Printed cheque forms were first issued between 1749 and 1759. Although, the Bank of England note continued to be supreme its notes were not popular beyond the metropolis, as the Bank did not have any outside branch. Private bank in the provincial cities began to play an important role after the middle of the 18th century, and their number continued to grow till it reached over 300 about the end of the century.

The crisis of 1825 marked a turning point, and tolled the death knell of the small country banks and of the note as the foundation of the banking system. Legislation quickly followed. It was realized that joint stock banks with the right of issue should be started outside London, and, therefore, in 1826 an Act was passed which allowed banks to be started with unlimited liability, consisting of more than six partners, with the right to Header issue notes, provided they had no office within a radius of 65 miles from London. This led to the starting of the joint stock banks in the country.[5]

However, the wrong impression, that no joint stock bank could be started within a radius of 65 miles from London, was removed by Mr. Joplin, who, after studying carefully the provisions of the various Charters of the Bank of England, came to the conclusion that no such monopoly was

intended. Opportunity was taken, on the occasion of the renewal of the Bank's Charter in 1833, to clarify the position of the inclusion, in the new Charter of Bank, of a cause giving legislative sanction to the establishment of joint stock banks in London, and in 1834, the London and Westminster Bank was started in London, being the first of the "Big Five".

At that time there was no limit to the amount of notes, which private bankers, and after 1826 the country joint stock banks, were allowed to issue, and this resulted in numerous banking crisis and bank failures. In 1844, another important stage was reached in the development of English banking when, by Peel's Act of that year, the right to issue notes in England was restricted to the banks then issuing notes in that country, as well as to the extent of their note issue at the time, thus providing for the gradual extinction of the right, and laying the foundation of the monopoly of bank-note issue for the Bank of England. This marks an important turning point in the history and development of English banking, and the deposit banking eventually came to supplement note issue banking.

After the passing of Peel's Act of 1844, new banks with the right to issue notes could not be started, and those allowed to issue notes could not increase their circulation. Thus greater attention began to be paid towards deposit banking and cheque currency. After 1890, the movement in favor of bank amalgamation and absorption made its appearance, and the number of joint stock banks, in England and Wales, came down from 104 in 1890 to 12 in 1956, although the number of banking offices shot up from 2203, to 10,700 by the end of 1961. In terms of Currency and Bank Note Act, 1920, the Currency Note issue as amalgamated with that of the Bank of England, which was given exclusive right to issue notes of £ 5 and upwards. In November 1929, the Bank of England organized a subsidiary company, named the Securities Management Trust Ltd., in order take charge of the work undertaken by the Bank in connection with the industrial re-organization, and in the year 1930, a new company named the Bankers Industrial Development Company Ltd., was created for bringing industry and finance to close relations. In 1947, the Labour Government nationalized the Bank of England, by transferring the then existing stock to the nominee of the British Treasury and by vesting in the Crown the power of appointing its Governor, Deputy Governor and Directors.[6]

The Socialization of banker in west had its impact on Indian Banking Industry also. The banks started enlarging its activities and started walking on a new path in sharp decision to the traditional path.

Now the banking system has increased the banking activity to many folds. They serve as custodians of stocks and shares and other valuables. Imports into and exports out of country are financed by banks, and documents relating to the goods so imported and exported, at one time or another, pass through the hands of bankers. Thus, they have to deal not only with bills of exchange, but also with bills of lading-railway receipts, warehouse warrants and receipts, marine insurance policies and various other documents. As bankers, they advance money on securities, and issue letters of credit, traveler's cheques, credit cards and circular notes to customers wishing in travel abroad, as also to effect purchases and shipment of goods. They are often required to countersign indemnities and guarantees given by their customers, and they undertake the administration of estates, thus assuming the position of trustees; they assist industrial undertakings by under-writing their debentures and shares, providing them with working capital finance and to a certain extent, with finance for fixed capital requirements also. They sometimes even obtain passports for their customers, and deal with their incoming mail. On behalf of their customers, they carry on correspondence with income-tax authorities; make periodical payments such as rents, taxes, subscriptions, etc. And, on instructions from their customers, act as executors of their customers wills: in short, they do all they can to assist their customers. The more highly developed a country is, the greater is the instrumentality of the banker utilized to carry through commercial transactions. From its original narrow scope and modest purpose, banking has developed to such an extent that it can truly be said that in countries, such as England and the Untied States of America, there is hardly a single business deal in which the assistance in one form or another of a bank is not sought for.

In India the banking industry is entering several new activities in the areas of merchant banking, leasing housing finance, venture capital and financial services in genera. The range of services provided by our banks stretches from rural finance at one end to international banking at the other. The banking scenario the world over is undergoing rapid diversification and technological change and Indian Banking can be no exception with the changing policy of the Government of India in the areas of industrial, trade and exchange rate policies. The functions of the bank have changed to cope with the changes.

Although, in recent years, the history of banking has begun to receive attention, thanks to research workers in this field, it is not necessary, for the purposes of this thesis, to give any detailed description of the banking system, which served this country before the advent of modern economy. However, banking in those days must have meant largely money-lending, financings kings and their wars, though certain

rudiments of modern banking functions were not unknown to the then bankers.

Bankers in India have always been regarded as very important members of the community in Government, as well as in social circles. Land revenue was generally collected in kind while the services were almost invariably paid in cash. In the traditional economy the private and individual Bankers played a very vital role. The banker's assistance was more or less indispensable in this connection. Even in other financial matters of State, he was frequently consulted. In the unsettled days of civil wars, when insecurity was so pronounced a feature of the times, the banker was most the only shelter in money matters. He was the only reliable agency for the deposit of jewellery, cash and hoardings in other forms, as was the cash with the goldsmiths in England in the 17th century. State officials had not much reputation in this respect. The Indian banker, however, was highly esteemed, and regarded as a worthy specimen of commercial morality. The time-honored adage: "No salvation except through the preceptor; no credit except through the money-lender," is significant in this respect.

Reference to the earliest system of banking prevailing in India can be traced from our scriptures and religious texts.

The word "Hundi" is said to be derived from the Sanskrit root "hund", meaning to collect. Its derivation expressed the purposes for which originally such instruments were used, and has gradually attained the meaning "Collection of debets".

In the days of the Mahabharata

The public confidence, enjoyed by the Indian banker, can well be realized from the fact that his Hundis (inland bills of exchange) date back to the days of the Mahabharata. Hundis were quite in vogue during the Middle Ages.[8]

Even in modern times, bills of exchange are generally used for the collection of debts. For instance, when a merchant in Bombay sells goods to a merchant in Delhi, the former draws a bill of exchange on the latter, so as to collect the price of those goods.

Similarly, when a merchant in Calcutta desires to collect a debt, due smaller networks and other connected machines. Internet allows information about almost every topic, be it books, encyclopedias, countries, people, organizations, etc. In short, it is a system of form a

[8]. Jain.D.C. India Indigenous Banking P 711.

smaller networks and other connected machines. Internet allows information about almost every topic, be it books, encyclopedias, countries, people, organizations, etc. In short, it is a system of from a merchant in madras; the former may draw a Hundi for the amount upon the latter.

Although probably strangers to the use of paper money, the Hindus, as we have seen had been accustomed to the use of the Hundi from verify remote times. Among them, the banking business was confined to the issue and discount of bills of exchange, money lending and money changing. Very soon, banking business was carried on along with dealings in grains cloth, etc. or with agency business. The importance of the part played by the banker in commercial markets, as well as in agricultural circles, cannot be denied. The transfer of funds from one place to another, at a fair distance, took place with the help of the Hundis. The agriculturists, even at the present time, in spite of the development of co-operative credit societies, have to depend, to a large extent, on the village bankers for financial assistance.

Bankers lent money against personal, as well an other securities, such as, ornaments, goods and immovable property. For everyday loans, the banker's knowledge of individuals and their financial position on account of the narrow circle in which these transactions had to be carried out rendered him more useful than even the modern commercial banks which are practically impersonal in their character, and are hedged round with many formalities, thereby sometimes annihilating their utility at the critical moment. The personal relations between the banker and his customers were of a cordial nature.

Usury, or high rate of interest, was widely prevalent in India. Most writers attribute usury to the state of insecurity in India, and the risk involved on account of the low financial status of the borrowers. No doubt, these factors played a great part, but they were not invariably, the only cause. The force of custom and limited communications barred the free play of economic forces of supply and demand.

This most apt definition of banking given by the Bombay Provincial Banking Enquiry Committee is not wholly applicable to money-lending, which hardly constitutes banking, as it is understood in the modern monetary world. The early Indian banker had comparatively a little of deposit or discount business, or dealings in other people's money which is the unfailing characteristic of modern banking. He may therefore, be called a money-lender rather than a banker.

The times have changed, and in India indigenous banking of the "good old days" has undergone many alterations, on account of the different forms and function, and the extreme complexity of modern business. All the same, the old system still retains its importance, though not to the same degree. The payment of taxes in cash, better means of communications and transpirations, uniform currency, the unification of the country under on Central Government, the development of the co-operative movement, and the establishment of joint stock banks, have taken away a good deal of business from the hands of the Indian money-lenders, still it cannot be denied that even today he occupies an important place in the credit organization of the country.

Although the role of the indigenous banker is fast dwindling as he is unable to adjust himself to modern banking conditions, it must be presumed that the private banker is not yet extinct. His activities have been generally in the agriculture retail trade sectors and is spread amongst the various classes of small borrowers but, with the present policy of the banks to meet the needs of this sector and opening of branches in the rural areas, the role of the indigenous banker will decrease rapidly specially if credit is provided to these hitherto neglected borrowers on reasonable terms without cumbersome procedures. The co-operative banking institutions are also playing an important role in removing the indigenous bankers from the field. The All India Rural Credit Survey initiated by the Reserve Bank of India in August 1951, had for one of its objectives the assessment of the position which indigenous bankers occupy at present in different parts of the country. Constructive proposals for linking rural areas with money markets have emerged from the findings of the Survey. Meanwhile, measures have been taken towards implementation of the recommendations of the Rural Banking Enquiry Committee including expansion of banking facilities in rural areas; these comprised, among others, the liberalization of remittance facilities available to commercial and co-operative banks and the opening during the period July 1955 to December 1960 by the present State Bank of India of 429 branch offices. During the last few years' further progress has been made in the opening of new branches both by the State Bank as well as other banks and several schemes for helping co-operative credit movement have been sponsored by the Reserve Bank of India. The total number of offices of Commercial Banks in India, where were 8,262 in June 1969 have reached an astonishing figure of above 75,000 at the end of 2005.[9]

➢ **Historical Background of Banking in India:**

The earliest operations in the field of banking in India can be traced from the Calcutta Agency Houses, the trading firms, which undertook banking

operations for the benefit of their constituents. Prominent among these were Messrs Alexander & Co, and Messrs Fergusson & Company.

That banking is incompatible with any other kind of business was illustrated by the commercial disaster of 1829-32. Banking needs to be run with great caution, while adventure to a certain extent is necessary for other kinds of business, e.g., industry and commerce. Reckless speculation, and a policy of placing profits before safety, was responsible for the failure of the agency houses which also involved and collapse of their banking departments. Having successfully withstood three severe runs on it, the Bank of Hindustan could not survive the failure of its parents firm in 1832 even in the case of the Solapur Bank Ltd, which went into liquidation in 1918; the failure was attributed to this fatal combination. Besides the usual banking business this bank had the power to do business of "Merchants or capitalists either as principal or agents. "The then Chief Justice of Bombay passed very strong strictures on such a practice.10 (Govind v. Ramnath, 32 Bom. L.R. 232), and suggested that legal prohibition of combining banking business with other commercial enterprises could have made what happened more difficult, if not impossible. The Indian Legislature recognized the principle of separation of banking business, from any other kind of commercial undertaking. Section 277 G(1) of the Indian Companies Act, 1013, laid down that no company formed after the commencement of the Act, for the purpose of carrying on business as a banking company or which uses as part of the name under which it proposes to carry on business, the word "bank", "banker", or "banking", shall be registered under the Act, unless its memorandum limits the objects of the company to the carrying on of the business of accepting deposits of money on current account, or otherwise subject to withdrawal by cheque, draft or otherwise, along with some types of business specified in Section 277F sub-section (2) of the Said section further provided that:

> "No banking company whether incorporated in or outside Indian Union shall after the expiry of two years from the commencement of the said Act carry on any form of business other than those specified in Section 277F.
>
> Provided that the Central Government. May, by notification in the Gazette of India specify in addition to the business set forth in clauses (1) to (17) of Section 277F other forms of business which it may be lawful under this section for a banking company to engage in".

The Indian Government did not awaken to the great need for banks in India till 1809, the year in which the Bank of Bengal obtained its charter with a capital of Rs.50 lacks, one-fifth of which was contributed by the

Government, who shared in the privilege of voting and direction. The charter restricted the bank's rate of interest to a maximum of 12 per cent. The power of note issue, however, was not given to the bank till 1823 in 1839; the bank was given the power to open branches and to deal in Inland exchange. The two other Presidency Banks, vi., the Bank of Bombay and the Bank of Madras were established in 1840 and 1843, respectively.12 As the notes issued by the Presidency banks did not become popular, they were replaced by Government paper money in 1862.

The year 1860 marks a new era in the history of Public Banks in India, because it was in this year that the principle of limited liability was first applied to the joint stock banks. So far, little or no banking legislation existed in India. May banks had sprung up like mushrooms and failed, mostly due to speculation, miss-management and fraud, on the part of those responsible for their flotation, organization and management.

It was unfortunate for India that the crisis of 1862-65 should have come so soon after the introduction of this important banking legislation. India's cotton exports increased by leaps and bounds, as a result of the outbreak of the civil war in the United States of America. This brought immense wealth in precious metals to India, which led, among other speculative enterprises, to the flotation of banks, soon to be overtaken by disasters. Among several others, the Bank of Bombay originally established in 1840 went into liquidation in 1868, although it was re-started in the same year and with the same name. The failure of almost all these mushroom growths prejudiced the Indian public, who is by nature conservative, against banks run on modern lines. Between 1865 and 1895 only two banks, the Allahabad Bank Ltd and the Punjab National Bank Ltd established.

- **Impact of Swadeshi movement:**

The Swadeshi movement, prompted Indians to start many new institutions, the number of joint stock banks increased remarkably during the boom of 1906-13. The Peoples Bank of India Ltd., the Bank of India Ltd., the Central Bank of India Ltd. Indian Bank Ltd., and the Bank of Baroda Ltd., was started during this period. The boom continued till it was overtaken by the crash of 1913-17, the most severe crises that the Indian joint stock banks have so far experienced.

The Presidency Banks referred to above, were amalgamated into the Imperial Bank of India, which was brought into existence on the 27th January, 1921, by the Imperial Bank of India Act of 1920. This Act, however, gave the bank no power to issue notes and thus left it without control over currency of the country. But it was allowed to hold

Government balances and to manage the public debt and clearing houses till the establishment of the Reserve Bank of India in 1935. The Reserve Bank of India took over all these functions from the Imperial Bank of India. Although the Imperial Bank of India was created by a special Act called the Imperial Bank of India Act, 1920, the liability of its shareholders, like that the shareholder of any other bank registered under the Indian Companies Act, was limited. The only difference was that the world "limited" did not form a part of its name. With the passing of the State Bank of India Act 1955 the Imperial Bank of India was converted to the State bank of India. It has the largest number of branches all over India, and does considerable business in commercial banking into a central banking institution of the country. Section 51 of the Baking Regulation Act, 1949 provided that without prejudice to the provision. Of the State Bank of India Act, 1955, or any other enactment, the provisions of Sections 10, 13 to 15,17, 19 to 21A, 23 to 28, 29 (excluding sub-section (3), sub-sections (1B), (1C) and (2) of Sections 30, 31, 34, 35, 35A, 36 (excluding clause (d) of sub-section (1),45Y, to 45ZF, 46 to 48, 50, 52 and 53 shall also apply, so far as may be to and in relation to the State Bank of India or any corresponding new bank or a Regional Rural Bank or any subsidiary bank as they apply to and in relation to banking companies.

Pursuant to the provisions of the State Bank of India (Subsidiary Banks) Act, 1959, the Bank of Bikaner, the Bank of Indore, the Bank of Jaipur, the Bank of Mysore, the Bank of Paitala, the Travancore Bank, the State Bank of Hyderabad and the State Bank of Saurashtra have been constituted as subsidiaries of the State Bank of India. This has extended the area of operation of the State Bank of India.

The earlier agency agreement between the former Imperial Bank of India and the Reserve Bank of India was replaced by an agreement between the State Bank of India and the Reserve Bank of India concluded on the 16th March, 1960 for the performance of agency functions.

The State Bank of India (Amendment) Act, 1959 simplified the procedure in regard to taking over of business of any banking institutions which the State Bank may acquire through negotiations under Section 35 of the State Bank of India Act, 1955. The Act also simplified the orderly winding up of the banking institutions, whose business is so acquired by the State Bank.

As stated earlier, the State Bank was constituted in July 1955 to take over the undertaking of erstwhile Imperial Bank of India. The Bank has made great strides since. It has played a pioneering role not only in moping up the country's savings but also in the financing of Industries

and rural credit. Its scheme for provision of credit to small scale industry needs special mention.[13]

➢ Evolution of Joint Stock Banks:

The Banking business is now carried on by the joint stock banking companies, although there exist some private banking institutions, indigenous banker and banks formed under special Acts or Royal Charters. We have already referred to the formation of the Imperial Bank of India in 1920 reconstituted into the State Bank of India in 1955. In spite of the fact, that banking business received no encouragement in its infancy from the Government. The Reserve Bank has made determined effort to place the banking and monetary structure of the country on a sound basis, either through advice or persuasion or through a well-devised system of inspection of banks. This function of the Bank has assumed a very great importance during the last few years owing to the failure of a few banks. It will not be incorrect to say that Bank's monetary and credit polices have played an important part in ridding the country out of the grip of inflation and stabilizing the economy. By the Reserve Bank Amendment Act of 1948, it has been invested with statutory powers to control and regulate the activities of the banking institutions. These powers have been considerably strengthened and reinforced from time to time by amendments to that Act, so much so that the Reserve Bank is now in a position to control and influence practically all-important aspects of the various activities, including managerial set up etc., of a banking company. The powers of Reserve Bank were extended over private banks also by the Banking Laws (Miscellaneous Provisions) Act, 1963.

As stated earlier, the ideas of having a Central Bank of the Country as a Controller of Banks as well as a promoter of the economic policies into reality with the establishment of Reserve Bank in 1935: Although suggestion have been made from time to time that India ought to have a Central Bank, they did not take definite shape until 1926, when the Royal Commission on Indian Currency and Finance recommended that a Central bank should be started in India so as to perfect her credit and currency organization. The Commission was not in favor of converting the Imperial bank of India into a Central Bank and consequently a bill to give effect to the recommendations was introduced in the Legislative Assembly on the 25th January, 1927, but it had to be dropped for constitutional reasons. The proposal assumed importance again in connection with the constitutional reforms, and a fresh bill was accordingly introduced by Sir. George Schuster in September, 1933. it was enacted in due course, and became law on the 6th March, 1934, and The Reserve Bank of India started functioning with effect from1st April 1935. The Reserve Bank of India has played an important role,

particularly during recent years. In the first quinquennium of its, life the Bank was new to its job and in consequence was slow in building up itself. In the next decade it was caught, like other Central Banking Institutions, in the grips of abnormal war time developments, with their stresses and strains on the country's financial mechanism. It is not always possible to have a complete idea of the part a Central Bank plays in regulating or formulating monetary policy, because of the Bank's intimate relations with the Treasury which, from their very nature, are more often than not shrouded in secrecy. At times the curtain is lifted (vide Sir. Chintaman Deshmukh's address on 2oth March, 1948 before the Gokhale Institute of Politics and Economics, Poona), and the public is then able to have an idea of the scenes that were being enacted on the monetary canvas. It can be said that the Reserve Bank has played a significant role, both during the war and post-war years, in helping to keep the monetary ship on an even keel.

The question which arises is why the Reserve Bank of India was nationalized in 1948 soon after Independence. There are two/three reasons which account for the nationalization of the Reserve Bank of India. Firstly, immediately after the end of Second World War there was a trend towards nationalization of central banks all over the world. Secondly, in India there was inflation right from 1939 onwards it was thought advisable to nationalize the Reserve Bank of India in order to control inflation in the country effectively. Thirdly, as India had to embark upon a programme of economic development and growth, it was necessary to have a complete control cover the activities of a central bank so that it could be used effectively as an instrument of economic change in his country.

The Reserve Bank of India performs all the important functions which are expected of a central bank. Most important are as Follows:-

a. The Reserve Bank of India issues and regulates the issue of currency in India. In fact the Reserve Bank of India is sole authority for the issue of currency in the country and thereby to regulate and control money supply in the country.

b. The Reserve Bank of India acts as a banker to Government. The Reserve Bank of India acts as a banker not only to the Government of India but also as a banker to the State Governments. The Reserve Bank of India looks after the current financial transactions of the Government and manages the public debt of the Government. As a banker to the government, the Reserve Bank of India has the obligation to transact the banking business of the Central Government. The Reserve Bank undertakes to accept money on account of

the Government, to make payment on behalf of the Government. It also carries out exchange remittance and other banking appertains including the management of public debts.

c. The Reserve Bank of India acts as a banker to the Commercial banks, just as the private individual keep and maintains their accounts with Commercial Banks; Commercial banks keep and maintain their accounts with the Reserve Bank of India. The commercial banks keep deposits with the Reserve Bank of India and they borrow money from Reserve Bank of India when necessary. In case of difficulties, the Reserve Bank of India acts as a lender of the last resort to commercial banks.

d. The Reserve Bank of India exercises its control over the volume of credit created by the commercial banks in order to ensure price stability.

e. The Reserve Bank of India has the responsibility to maintain not only the internal value of the currency, i.e., the Indian Rupee, but it has also to maintain the external value of the currency. In short the Reserve Bank of India is largely concerned with organization of a sound and healthy commercial banking system, ensuring effective co-ordination and control over credit through appropriate monetary and credit polices followed from time to time. However, in India the Reserve Bank of India is also concerned with development of rural banking, promotion of financial institutions and development of money and capital market in India.

- **Banker's Service to public:**

The Reserve Bank of India, as a central bank of our country, has to perform not merely the negative role of controlling credit and currency in the economy to maintain the internal and external value of the rupee to ensure price stability in the economy, but also to act as a promoter of financial institutions in the country so that its policies could be effective in promoting economic growth as per the guidelines and polices formulated by the Government. When the Reserve Bank of India was established in 1935, our country was a backward country, which lacked a well-developed commercial banking system apart from the absence of well-developed money market in the country. After 1948 the Reserve Bank of India became very active to take steps to promote and develop financial institutions so that the

Reserve Bank of India can pursue appropriate credit and monetary policies for economic growth and development in an era of planned economic development of the country.

The Reserve Bank of India has, therefore, taken the following steps as promotional measures: [5]

(1) The Reserve Bank of India established the bill market scheme in 1952.
(2) The Reserve Bank of India has tried to help the establishment of financial corporation to provide credit to the agriculture sector of economy and also the industrial sector of the economy.
(3) The Reserve Bank of India has promoted regional rural banks with the help of commercial banks to extend banking facilities to rural areas.
(4) The Reserve Bank of India has taken steps to enable the commercial banks to open branches in foreign centers and has helped the establishment of an export-import bank in India to provide finance to exporters.
(5) The Reserve Bank of India encourages and promotes research in the areas of banking.

➢ **Banking Organization (RBI):**

The affairs of the Reserve Bank of India are managed by the Central Board of Directors. The Central Board of Directors consists of:

(1) A Governor and not more than four Deputy Governors appointed by the Central Government under Section 8(1) (a) of the Reserve Bank of India Act, 1934,
(2) four Directors nominated by the Central Government, one from each of the four Local Boards in terms of Section 8(1)(b),
(3) Ten Directors nominated by the Central Government under Section 8(1)(c)
(4) One Government official nominated by the Central Government under Section 8(1) (d).

The Reserve Bank of India has a Local Board with Head quarters at Bombay, Calcutta, Madras and New Delhi, Local Boards consists of five members and these members are appointed by the Central Government to represent territorial and economic interest and the interest of co-operatives and indigenous banks.

The Chairman of the Central Board of Directors of the Reserve Bank of India is called the Chief Executive Authority of the Bank and he is known as the Governor. He Governor has the powers of general

Superintendence and direction of the affairs and business of the bank and he is authorized to exercise all the powers which may be exercised by the bank. In the absence of the Governor, the Deputy Governor nominated by him exercises his powers.

The Commercial Banks maintain accounts with the Reserve Bank of India and borrow money when necessary from the Reserve Bank of India. He Reserve Bank of India thus provides credit to commercial banks and commercial banks in turn provide credit to their clients to promote economic growth and development. However, credit cannot be extended to an unlimited extent because it would disturb price stability in the country and therefore, it becomes necessary for the Reserve Bank of India to control the activities of the commercial banks in the interest of price stability. The Reserve Bank of India controls the activities of the commercial banks by virtue of the powers vested in it under the Banking Regulation Act of 1949 and Reserve Bank of India Act, 1934.16

Under the Banking Regulation Act, 1949, the Reserve Bank of India is given a power to issue license to commercial banks to open branches. No commercial bank can commence the business without obtaining license from the Reserve Bank of India. The Reserve Bank of India has also power to withdraw the license once granted in case it is found the affairs of the bank are not managed properly. The Reserve Bank of India has been given a power to inspect the commercial banks under Section 17 of the Banking Regulation Act. Under this power, the Reserve Bank can itself at any time cause an inspection to be carried out by one or more of its officers of any bank and its books and account and if there are defects, the banks concerned are required to rectify them and the Reserve Bank of India has power to appoint Additional Directors on the Boards of Directors.

Under the Banking Regulation Act, the Reserve Bank of India has wide powers of over-all control over the management of banks. Under this Act, Section 18, the approval of the Reserve Bank of India is necessary for the appointment or re-appointment or termination of an appointment of a Chairman, Managing or whole Time Director. The Reserve Bank of India has a power to prevent a commercial bank from undertaking certain types of transactions.

Under Section 21, the Reserve Bank of India has been given a power to control advances granted by the commercial banks. This power is known as the power of Selective Credit Control. Under this Section, the Reserve Bank of India is empowered to determine the policy in relation to advances to be followed by banks generally or by any bank in particular and under this Section, the Reserve Bank of India has been authorized to issue directions to banks as regards the purpose of the advances, the

margins to be maintained in respect of the secured advances and it can also prescribe the ate of interest and other terms and conditions on which advances may be made.

Apart from the Selective Control of Credit exercised by the Reserve Bank of India, the Reserve Bank of India controls the volume of credit in a quantitative way so as to influence the total volume of bank credit. The Reserve Bank of India does this through the use of following instruments:

(1) The Bank Rate
(2) Open Market Operations
(3) Variable Cash Reserve Requirement

The Bank Rate is the rate of interest at which the Reserve Bank of India re-discounts the first class bills of exchange from commercial banks or other eligible paper. Whenever the Reserve Bank of India wants to reduce credit, the bank rate is raised and whenever the volume of bank credits is to be expanded the bank rate is reduced. This is because by change in the bank rate, the Reserve Bank of India seeks to influence the cost of bank credit. However, the efficacy of the bank rate depends on the extent of integration in the money market and also it depends upon how far the commercial banks resort to borrowings from the Reserve Bank of India.

The Reserve Bank of India can influence the reserves of commercial banks, i.e., the cash base of commercial banks by buying or selling Government Securities in open market. If he Reserve Bank of India buys Government Securities in the market from commercial banks, there is transfer of cash from the Reserve Bank of India to the commercial banks and this increased the cash base of the commercial banks enabling them to expand credit and conversely if the Reserve Bank of India sells Government Securities to the Commercial Banks, the commercial banks transfer cash to the Reserve Bank of India and therefore their cash base is reduced thus adversely affecting the capacity of commercial banks to expand credit. The success of open market operation as a technique of credit control depends upon of size of Government Securities available, their range in variety and the ability of the market to absorb them.

The commercial banks are required to keep a certain percentage of deposits as reserves with the Reserve Bank of India. The Reserve Bank of India is legally authorized to raise or lower the minimum reserves that the bank must maintain against the total deposits. If the percentage of reserves to be maintained is increased, the commercial banks will be left with less cash and therefore, they have to contract credit and if this limits reduced, the commercial banks will have more cash with them and

they would be able to expand credit. The Reserve Bank of India has got the power to use the variable reserve requirements as instruments. Of monetary control only in 1956 when the bank was authorized to vary the minimum cash reserve requirement to be maintained by commercial banks between 5% and 20% of demand deposits and 2% and8% of time deposits.

In addition to this, the Reserve Bank of India was empowered to impound banks' reserves in excess of a certain level reached in a phased period. The commercial banks are also required to maintain Statutory Liquidity Ratio and to arrive at the statutory liquidity ratio; the following assets are taken into account.

(a) Cash in hand in India.
(b) Balance in the current accounts with State Bank of India and its subsidiaries in India.
(c) Balances with Reserve Bank. In excess of the minimum reserve requirement at 7 per cent of total demand and time liabilities.
(d) Investments in Government Securities, treasury bills and other approved securities in India

Borrowings from the Reserve Bank of India against approved securities and borrowings from State Bank of India and other notified banks. The remainder of the liquid assets expressed, as a percentage of the total demand and time liabilities is the statutory liquidity ration.

Thus the Reserve Bank of India has been empowered to control the volume of credit quantitatively through the use of bank rate, open market operations and variable reserve requirements apart from impounding of deposits beyond a certain level and the Reserve Bank. An influence the volume of credit in certain selected areas through the use of selective credit control by prescribing the margins to be maintained in respect of secured advances against commodities, rate of interest on advances and by regulating the purpose or purposes for which advances may or may not be granted by the banking system as a whole or by group of banks or by a single bank as the case may be.

- **Establishment of Financial Institutions:**

The Narasimhim Committee recommended that the supervisory function be separated from the more traditional central banking functions of the Reserve Bank and that a separate agency which could be a quasi-autonomous Banking Supervisory Board under the aegis of the Reserve Bank be set-up. The Committee also proposed that the Board should have supervisory jurisdiction not merely over the banking system but

also over the development finance institutions, non-banking financial intermediaries and other Para banking financial institutions.

The Government has approved the statutory regulation under the provisions of Section 58 of the Reserve Bank of India Act, 1934 in connection with the setting up of the Board for Financial Supervision and notification has been issued to this effect on 28.7.1993 to give operational support to BFS. The Board will undertake supervisory of commercial banks and in due course its supervising functions would be extended to financial institutions and non-banking financial companies as well. The department of supervision has been set-up with its Central Office at Bombay and 16 Regional Offices at various Centers:

The DOS is presently designing an appropriate reporting system to enable it to exercise off-site surveillance over commercial banks. Special investigations including those connected with compliance and frauds and the work relating to appointment of statutory auditors for 217 public sector banks and 7 public financial institutions and the Reserve Bank are being attended to by the new department.

Under Section 35A of the Banking Regulation Act, 1949 the Reserve Bank may issue directions to banking companies who are bound to company with such directions.

➤ **Concept of Social Obligation and Social Control:**

The classical function of a Central Bank in a country is to control the currency and credit of that country and to mobilize its reserves, but the constitutional structure and powers vary in details according to the prevailing economic conditions, the organization of money and capital market, etc., in a country. No doubt due to the acute economic conditions prevailing in India as well as all over the world during the last few years, the functions of a Central Bank have become more important. The words of the Macmillan Committee "that a Central Bank is expected to keep the financial structure upon an even keel" still hold good. Broadly speaking, a Central banking Institutions has to stimulate banking enterprises in the country. The development of saving habits and the utilization of idle money are still the dominate problems of Indian banking. The Reserve Bank's first duty is to see that the banking business is carried on sound principles as well as to help the provision of banking facilities all over the country. The growth of banking cannot be fostered by mere laws, as has been brought out by the failure of Palai Central Bank in Kerala, nor can it be developed by any artificial means and ingenious devices. It is gratifying to record the part played by the Reserve Bank in the field of banking legislation and control. In the field of agricultural credit and industrial finance also, the bank is doing

considerable pioneering work and assisting the Government of India. Thus, the present activities of the Reserve Bank combine traditional Central Banking functions with developmental activities and the dynamic role played by it in either sphere-has not only put the national economy on a surer footing but has also been instrumental in the planned development of the country. Recently with the Government policy of liberalization and globalization, the duty and role of Reserve Bank has increased and it is making effort to stabilize the inflation by control of flow of money and other credit control. The foreign exchange balance, which became very low, has increased to a great extent by the steps taken by the Government of India on the advice of Reserve Bank of India.[19]

Co-operative Banks have also played a limited but important role in the banking system of the country. There are number of such banks which include State Co-operative Banks (SCBs), Central Co-operative Banks (CCBs), Primary (Urban) Co-operative Banks (PCBs), Land Development Banks (LDBs), Primary Agricultural Credit Society (PACs), Farmer Service Societies (FSS), Large-sized Adivasi Multi-Purpose Societies (LAMPS).

The functions of co-operative banks are mainly to cater to the need of the rural areas and small borrowers and are concerned more with the financing of agriculturists. Although they also perform the main banking functions, their range is limited as compared to that of commercial banks.

- **Nationalization of Banks:**

From 1.2.1969 the Government imposed "Social Control" on banks by introducing certain provisions in the Act. It imposed severe restrictions on the composition of the Board of Directors and internal management and administration of banking companies. It also introduced restrictions on advances by banking companies. These were intended to ensure that the bank advances were not confined to large scale industries and big business houses, but were also directed, in due proportion, to other important sectors like agriculture, small-scale industries and exports.

With effect from the 19th July, 1969 fourteen major Indian Banks having deposits of more than Rs 50 crores were nationalized. The Undertakings of these fourteen Banks were taken over by and have vested in 14 new corporate bodies established under the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970. the Banking Companies (Acquisition and Transfer of Undertakings) Act, 170 has been amended Banking Companies (AcquistioOn and Transfer of Undertakings) Amendment Act, 1994, according to which the share capital up to 49% of the nationalized banks can be held by the public and cost of the share

capital will be owned by the Government of India. These fourteen banks are now managed by the Government of India through the Board of Directors appointed by it.

On 15th April, 1980 six more banks having demand and time liabilities of not less than Rs.200 crores were nationalized. The undertakings of these banks are taken over and vest in six corresponding new banks under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

In 1931 the Indian Central Banking Enquiry Committee had made a detailed study of the working and problems of banking in India. Before a number of Committees such as Chamberlain Commission of 1914 and Hilton Young Commission had reviewed and reported on the banking structure of the country. The repeated changes and developments which have taken place in the banking system in India since the termination of the second world war and Independence, reflecting necessary changes in the political ideology, have during the period affected very much the thinking, attitudes, objectives and working of the banking industry. With a view "to take a close look at the banking system" a Commission under the Chairmanship of Mr. R.G. Saraiya was appointed in 1969. The terms of reference of the Commission were very wide and exhaustive and included the examination of the structure and the operations not only of the commercial banks but also of co-operative and financial institutions as well as financial activities. The recommendations cover all aspects of the terms of reference and are divided into 5 major areas: (a) Sharpe, structure and organization of banking, financial and specialized institutions; (b) Re-organization of their functions and service; (c) Simplification of systems and procedures for improving efficiency and reducing costs; (d) Legislation for promoting growth and ensuring regulation; and (e) Management development, management information and research.[23]

One of the main proposals relates to the reconstruction of the banking system. At present there are 29 public sector banks consists of the State Bank of India, its seven subsidiaries and the 20 nationalized banks. According to the Commission, these are too many. So the Commission has put forward a plan under which these will be "recognized" into eight or nine banks, consisting of there all-India banks (the State Bank and two the nationalized banks with widespread branch network) plus five or six regional banks with overlapping jurisdiction over the neighboring areas. The guiding factor in this suggested reform of the structure is that a reasonable choice will always be available to bank customers to choose their banks, and that the proposal will ensure that persons residing in district towns will have a choice between the three all-India banks and at lest two regional banks. For places smaller than district

towns, there will be at least two commercial banks in each district in addition to the network of co-operative banks. This suggestion has been considered at different levels, but it does not appear to have found favor with Government or banking circles. Apparently the implementation of such a scheme would raise several administrative and personnel problems which would cancel out the benefits, if any, arising therefore. It is also believed that retention of the identity of individual banks has kept up a spirit of healthy competition which ha been helpful in the defaulter of banking on sound lines. The retention of the identify of banks which have along history and tradition has been helpful in fostering a sense of belonging in the staff and executives which makes them take a keen interest in the progress and development of the institutions to which they belong.[24]

- **Implementation of the Banking Commission's & Recommendations:**

The Government of India has studied the report of Baking Commission and has taken a decision on some of the committee made by the Commission. The Reconstruction on which decisions have been taken by the Government soar is as under:

1. The Government of India has accepted almost all the recommendations made by the Commission in regard to the banks' operating methods and procedures so as to achieve simplification of credit procedures and rationalization of internal control system and organization management in order to improve functional and operational efficiency. However, the Government has not accepted two recommendations of the Commission:

   (i) The committee to establish a common inspection agency for all banks has not found favor with the Government.

   (ii) The Bank Giro system recommended by the Commission has not been accepted.[25]

2. The Government has not accepted the recommendations of the Commission for establishment of a separate merchant banking institutions. This is because the Government wants to study the progress of merchant banking divisions set up by leading commercial banks in the country.

   The Government has not accepted the recommendations for setting up specialized institutions for consumer credit. The Government agrees with the Commission that there is no need for a specialized savings bank or specialized discount house in the country. However, the Reserve Bank might consider on merits proposal from persons of other banks and specialized institutions

for promoting acceptance or discount houses. The Discount and Finance House of India (DFHI) has now been set up w.e.f. July 28, 1988.

3. The Government is amending some of the statues governing banks in view of the recommendations made by the Commission. Section 19 of the Banking Regulation Act is amended to allow the banks to form subsidiaries for carrying on any business permitted to be transacted under the Act. The Banking Commission felt the necessity for evolution of a uniform scheme for national banks if they have to have a common programme of functions and responsibilities in the development of banking and credit system in the country. The committee involves mainly the question of effecting amendments to the statutes under which these banks have been established. Some amendments have already been effected recently to the State Bank of India Act taking into account the Commission's recommendations for a uniform scheme. The Government has constituted a public service commission for the recruitment of the banking personnel in the nationalized banking industry. The Banking Service Commission Act, 1984 (Act 44 of 1984) has been enacted in this regard. The Banking Laws (Amendment) Act, 1983 (Act 1 of 1984) has also amended the Banking Regulation Act, 1949 and some other Acts in pursuance of the recommendations of the Banking Commission.

The Government of India set up a Committee under the Chairmanship of Shri M. Narasimham to examine the (I) existing structure of the financial system and its various components and to make reconstruction for improving the efficiency and effectiveness of the system with particular reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions (ii) to make recommendations for improving and modernizing the organizational systems and procedures as well as managerial policies, (iii) to make recommendations for infusing greater competitive viability into the system so as to enable the banks and financial institutions to respond more effectively to the emerging credit needs of the economy and other related matters. The Committee submitted its report to the Government on all the issues and made recommendations; among other things restricting the banks and change of policy to make the banks and financial institutions viable. The Committee also recommended capital adequacy norms for the banks. The Government of India and Reserve Bank have accepted, any recommendations of the Committee and taken steps to implement the said recommendations.[26]

➢ Evolution and Development of Banking Law in India:

The Law of contract, the Law of Torts and other branches of Commercial and Civil law are applicable to banks as to others. It may be stated that Indian Banking law is based to a very large extent, though not entirely, upon the English Banking law; it is therefore, necessary to pass in review the main landmarks of the history of banking legislation in England.

Banking law in general is a part of the law merchant, or as it is sometimes known Lex Moratoria. Lex Moratoria began to take its shape in the 13th century and it was based upon the customs of merchants. Gradually these customs were ratified by courts of law, and became a part of the general law, which courts were bound to recognize. No doubt additions were made from time to time. The practice of marking bills of exchange payable to order and transferring them by endorsement dates back to the beginning of the 17th century. In 1964, the first Banking Act, which brought into existence the Bank of England, was passed. This was followed by acts passed in 1826 and 1833. None of these pieces of legislation dealt generally with banking law, as they dealt with only a few aspects of the banking business. In 1836, attention was drawn in the House of Commons against "the vast and growing system of joint stock banking" and the necessity for statutory regulation of banking "As a result an Act was passed in 1844 which provided for (a) subscribed and paid-up capital of new banks' (b) permission for opening new banks; (c) retirement of directors every four year in rotation and prohibition of re-election for two year after retirement; (d) prohibition of loans against banks; own shares; and (e) publication of balance sheets once a month.[27]

During the post-industrial revolution period Banking Law was largely judge-made-law, which was the outcome of the recognition of certain customs governing banking and commercial practices. Lord Mansfield whose name is considered perhaps the most important in the history of English mercantile law, tried to lay the foundation of English banking and commercial law upon the customs of merchants of the advanced European countries. The rulings of Lord Mansfield, which were considered the most important and authoritative pieces of judge-made law, continued to be the law on the subject, and later, whenever the law pertaining to banking or commerce was codified, it was based mostly on the rulings or judgments of Lord Mansfield and certain other judges.[28]

Speaking generally, the English Law relating to negotiable instruments was applied by courts in India, when the contesting parties were Europeans, but, in the case of the Hindus and Mohammedans, their was

27.Journal of NIBM: June 1982

applied by courts in India, when the contesting parties were Europeans, but, in the case of the Hindus and Mohammedans, their respective laws and usages were made applicable; where, however, the parties belonged to difference communities; the law and usage which governed the defendant were applied. As neither the Hindu texts dealing with hundies, nor the Mohammedan books on the subject, dealt adequately with the matter, customs prevailing among merchants of the respective communities were recognized by the courts.

Act of 1840 represented the earliest attempt in this country to regulate the law relating to bills of exchange and promissory notes. In 1866 a Bill to codify the law regarding negotiable instruments was drafted; the draft underwent several changes and it was not until 1881 that the Indian Negotiable Instruments Act was passed.

The Negotiable Instrument Act 1881 recognizes local usages and certain customs prevalent among Indian merchants. It extends to the whole of India, but does not affect local usages relating to instruments in India languages.[29]

There was no clear indication in the Act, whether the local usages of the place where an instruments was made or of the place of its payment was to apply when the two differed. The question in each case was to be decided probably by a reference to the intention of the parties to the Instruments. Sir Henry Chalmar, in his commentary on the Negotiable Instrument Act has given rules relating to foreign instruments which may lend useful guidance to the determination of the question. The title Instrument Act has given rules relating to foreign instruments which may lend useful guidance to the determination of the question. The title of the Negotiable Instrument Act itself is considered misleading, as the Act does not deal with all kinds of negotiable instruments. It is for this reason that the English statute on the same subject is known as the Bills of Exchange Act.

The Negotiable Instrument Act, as its preamble shows, is intended "to define and amend the law relating to promissory notes, bills of exchange of 'cheques', whether negotiable or not." Moreover, the Indian Act even now is not as comprehensive as it should be, although it has been amended several times, since the passing of the Act 27.

There was some time a variance in law in practice and theory due to slow

28. Journal of Indian Institute of Banker Dec: 1988
29. Sec: 1 of N.I. Act.

fusion of English Banking Law in India. This anomaly was brought home to by a ruling of the Bombay High Court where the point involved was, whether striking off the word "bearer" on cheque, without adding the word "order", amounted to a restriction of the rights of the payee to negotiate Income Tax although evidence was given to prove that the bankers, in Bombay, as in England, treated such cheques as order cheques, the learned judge held that the law of this country as it stood then, did not allow it, and, therefore, such cheques were not negotiable.[30]

Negotiable Instrument Amendment Act, 1919 however, removed this incongruity between banking law and practice in India. Similarly, although in England the protection given to the collecting banker was extended to crossed cheques, credited, though not collected it was not given to bankers in this country, until the law was amended.

The next importance piece of legislation which is made for Bankers alone in this country is the Bankers' Books Evidence Act, 1891. it is a special Act giving certain privileges to Banks as regard the mode of proving of entries in their books and the production thereof in Courts of law.

The law of evidence requires that the existence, condition or contents of a document can be proved before a Court only by producing the original document. So long as the original document is available a copy cannot be produced Section 65 of Indian Evidence Act lays down certain exceptions to this Rule and allows copies of a document to be produced before a Court even when the original is available. One of such an exception is when the original is document of which a certified copy is permitted by any law. The Bankers' Books Evidence Act is one of the provisions of the law which allows the production of certified copy of a document.

There are two important definitions in that Act which are necessary to understand its provisions. One such definition is of "Bankers' Books" as given in Section 2(3) of the Act as under:

> "Bankers' Books" include ledgers, day books, cash books, account books and all other books used in the ordinary business of a bank.

The other definition is that of "a certified copy" given in section 2(8). The section as amended by the Banking Laws (Amendment) Act, 1983 (Act 1 of 1984)

30. Bhashyan and Adiga: Negotiable Instruments Act (Delhi) Current Publications (1999).
31.Journal of NIBM: June 1982

"Certified copy" means a copy of any entry in the books of a bank together with a certificate written at the foot of such copy that it is a true copy of such entry, that such entry is contained in one of the ordinary books of the bank and was made in the usual and ordinary course of business, and that such books is still in the custody of the bank, and where the copy was obtained by a mechanical or other process which in itself ensured the accuracy of the copy, a further certificate to that effect, but where the book from which such copy was prepared has been destroyed in the usual course of the bank's business after the date on which the copy had been so prepared, a further certificate to that effect, each such certificate being dated and subscribed by the principal accountant or manager of the bank with his name and official title.

The Amendment Act, 1983 has amended this clause so as to provide that a copy made from the original document by mechanical or other process ensuring the accuracy of such copy, together with a certificate to that effect, s also a copy prepared from the original document prior to the destruction of the original by a bank in the usual course of its business, together with a certificate to that effect shall be admissible in evidence. The amendment is based on the recommendations of the Banking Commission.

Section 4 of the Bankers' Books Evidence Act reads as under:

"Subject to the provisions of this Act, a certified copy of any entry in a banker's book shall in all legal proceedings be received as prima facie evidence of the existence of such entry, and shall be admitted as evidence of the matters, transactions and accounts therein recorded in every case where, and to the same extent as, the original entry itself is now by law admissible, but not further or otherwise."[31]

Having regard to the language of the section, it should be borne in mind that the Act merely authorizes certified copies to be produced instead of the originals and does not in any way affect the provisions of the Evidence Act regarding the proof of a document. In Chandradhar Goswami v. Gauhati Bank Ltd.[32] the facts brought to the notice of the Supreme Court were that in the suit before the trial court Gauhati Bank Ltd., relied on the certified copy of its books to prove that a sum of Rs.10, 000/- was advanced to the defendant. The defendant contended that the accounts of the Bank were not kept correctly in the regular course of business and were fraudulent and were therefore not relevant and not admissible in evidence. The Supreme Court held that in view of the

32. United Industrial Bank Ltd V V.G.Dey

contention of the defendant mere reliance by the Bank on the production of certified copies was not sufficient. The basis of this view was section 34 of the Evidence Act which provides that "entries in books of accounts, regularly kept in the course of business, are relevant whenever they refer to a matter into which the Court has to inquire, but such statements shall not alone be sufficient evidence to charge any person with liability". Since the bank wanted to charge the defendant with the liability of a debtor, the certified copies would not constitute evidence for the purpose. The Court held that the certified copies are of the evidentiary value to the same extent as the original entry itself and no further. Therefore, where the entries are not admitted, it is the duty of the bank, to produce evidence in support of the entries to show that the money was advanced, and thereafter the entries would be of use as corroborative evidence. An officer of the plaintiff bank produced a statement of account of the defendant with the bank duly certified by the Branch Manager under the Bankers' Books Evidence Act and deposed to the correctness of the statement. It appeared that a certain sum was due and the plaintiff demanded payment of the overdraft balance then outstanding by two letters the copies of which were also produced, but the defendant failed and neglected to pay the same. The Court held that the plaintiff's claim ought to succeed although the defendant filed a written statement and chose not to appear.[33]

Section 4 of the Bankers' Books Evidence Act reads as under:

> "No officers of a bank shall in any legal proceeding to which the Bank is to a party be compellable to produce any banker's book, the contents of which can be proved under this Act, or to appear as a witness to prove the matters, transactions and accounts therein recorded, unless by order of the Court or a Judge made for special cause".

It must be noted that the above section applied only when the bank is not a party to the proceeding. Further, the section does not apply to an investigation by a police officer. Under Section 94 of the Criminal Procedure Code, an officer in-charge of a Police Station can compel a Bank officer to produce the books without the order of a Court.[34] (A.F.G. Price v. Emperor).

Section 2(4) of the Bankers' Books Evidence Act, 1891 as amended by the Banking Laws (Amendment) Act, 1983 reads as under:

> 'Legal proceedings' means-

33.AIR.1974.cal 154

(i) any proceedings or inquiry in which evidence is or may be given;
(ii) an arbitration; and
(iii) any investigation or inquiry under the Code of Criminal Procedure 1973 (2 of 1974), or under any other law for the time being in force for the collection of evidence, conducted by
(iv) a police officer or by any other person (not being a Magistrate)
(v) authorized in this behalf by a magistrate or by any law for the time being in force".

The Amendment Act, 1983 has amplified the definition of the term "legal proceeding" by including therein any investigation or inquiry under the Code of Criminal Procedure, 1973, or under any other law for the time being in force for the collection of evidence conducted by a police officer or by any other person (not being a magistrate) authorized in this behalf by a magistrate or by any law for the time being in force. The amendment is based on the recommendations of the Banking Commission.

Section 6 of the Bankers' Books Evidence Act reads as under:

(1) "On the application of any party to a legal proceedings the Court or a Judge may order that such party be at liberty to inspect and take copies of any entries in a Banker's book for any of the purposes of such proceeding or may order the bank to prepare and produce, within a time to be specified in the order, certified copies of all such entries, accompanied by a further certificate that no other entries are to be found in the books of the bank relevant to the matters in issue in such proceedings, and such further certificate shall be dated and subscribed in manner here-in-before directed in reference to certified copies.

(2) An order under this or the preceding section may be made either with or without summoning the bank, and shall be served on the bank three clear days (exclusive of bank holidays) before the same is to be obeyed, unless the Court or judge shall otherwise direct.

(3) The bank may at any time before the time limited for obedience to any such order as aforesaid either offer to produce their books at the trial or give notice of their intention to show cause

against such order, and thereupon the same shall not be enforced without further order."

It is in the discretion of the Court to order that a party to a legal proceeding can inspect and take copies of Bankers' books. An order under the section is made only when the entries are relevant for the purpose of any issue in the proceeding. Courts are always averse to giving anything in the nature of a roving or fishing inquiry when commissioning to inspect document (Central Bank of India Ltd. V. Shamdasani).[35]

Where the inspection of the books of a third party was sought the Court held that the same ought not to be allowed as it involves a serious inroad upon his normal right as a citizen. (Satyanarayan v. Punjab National Bank,) [36]

The words "party to a legal proceeding" used in Section 6 of the Bankers' Books Evidence Act enable inspection to the made only if such inspection was necessary for the purposes of such proceedings. In other words there should be a main proceeding in which the court might came to the conclusion that such inspection was necessary and it would only in such proceeding that order could be passed for inspection. If there is no legal proceedings pending, the court cannot order for the inspection of Bankers' books under Act (Kattabomman Transport Corporation. Ltd. v. State Bank of Tranvancore).[37]

The Banking Laws (Amendment) Act, 1983 has incorporated a new Section 8 in the Bankers' Books Evidence Act, 1981, so as to provide that the order of a court or judge for production and inspection of books of the bank shall be construed as referring to an order made by an officer of a rank not lower than a Superintendent of Police as may be specified in this behalf by the Government by which the police officer or any other person conducting the investigation or inquiry is employed.

35. (39) Bombay L.R.1187
36. (39) Bombay L.R.1187
37. AIR 1977 Cel 280

CHAPTER – II

CREDIT MANAGMENT BY BANKS

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CREDIT MANAGEMENT BY BANKS

Credit is the life blood of commerce. India being a developing country and being poor in the formation of capital depends heavily on the banking system to mobilize finance for growth of the economy. The banking system in turn mobilizes deposits from the savings of the public and makes these funds available for investors. This process of intermediation enables the banking system to multiply deposits and credits. By this turnover, deposits create loans and loans create deposits'. The investors/borrowers are expected to repay the loans either in installments or in lump sum and also pay interest thereon, i.e., a cost on the borrowed funds. These earnings by the banks are again made available to the investors/borrowers by way of credit. Thus, the fast and frequent recycling of fund through fresh credit creation contributes to the banking survival, efficiency and profitability. The system's profit is the difference between the interest that it pays on deposits and what it earns in making loans. The system's success is greatly linked to deposit money with them. The problem that the system encounters is that while the deposits have to be paid back their money on demand or after a term, the funds made available to borrowers. Investors may not come back on due date or may not come back in full or may come back after inordinate delay or may not come back at all. Similar is the case with interest on money lend. This situation results in a mismatch between maturities of deposits and advances, which has to be taken care of by banks' themselves borrowing funds from the market. The market loans often cost more than the deposits, thus increasing the average cost of funds to the banks and consequently increasing the cost on loans extended to their borrowers.

In order to ensure the soundness of the banking system and protect depositors' interests, Reserve Bank of India, as Bankers' Bank has been entrusted with the responsibility of regulating and supervision the banking system in terms of Reserve Bank of India Act 1934, and Banking Regulation Act, 1949 (B.R. Act). As a regulatory measure, Reserve Bank of India has prescribed certain minimum reserve requirements which the banking system has to statutorily comply with. Accordingly Cash Reserve Requirements (CRR) and Statutory Liquidity Requirements (SLR) have been specified as a charge on the banking system's not demand and time liabilities. These requirements are subject to change from time to

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1. Gopal Swaroop, Banking in India (Del) Himalaya, i987. p.6

2. Ibid. p 36

time as the money supply position in the economy would demand. While Cash Reserve Requirements ensure liquidity to the banking system, they also indirectly influence the money supply and stabilize the price levels. Statutory liquidity requirements ensure safe and sound investment of part of bank funds in Government Securities and other approved Securities and hedges the liquidity risks of the banking system and continue to ensure the ability of the banking system to meet the liability to the depositors as and when they arise.

- **Cash Reserve**

The banking system also has the social responsibility to develop the rural economy and alleviate the poverty of the masses. This is done by requiring the system to invest 40 per cent of its net bank credit in priority sector areas (agriculture, small scale sector and tiny sector) as prescribed by Reserve Bank of India. The banking system has also been under obligation to provide export credit up to a specified level and to charge lower interest in recognition of the country's need to earn foreign exchange through exports thus, the banking system has to earmark for every Rs 100 of deposit received, Rs 4.75 towards CRR, Rs 25 towards SRLR. Further, the net banking credit, priority sector advances will cover 40 per cent, export credit 12 per cent and food procurement operations of Government of India, roughly 10 per cent at comparatively lower rate of interest. After meeting all these statutory requirements, since the funds available for normal commercial lending are very limited and their contribution to capital is insignificant compared to operations, the banking system after resorts to borrowings from the markets to supplement its resources. This situation compels the banks to charge higher rate of interest on other categories of borrowers.

- **Factors governing cash reserve:**

One of the main defects of Indian Banking system is the week and vulnerable capital of many banks. The fact is evident that during the years 1934 to- 1945, as many as 715 banking companies were liquidated or wound up due to very poor capital base. Section 11 of the Banking Regulation Act, 1949 takes care of this aspect. Under Sub-section 2 of Section 11, Foreign Banks have to deposit with the Reserve Bank of India Rs. 15 lacs, and if, they want to operate in Bombay or Calcutta, or both, Rs. 20 lacs. This amount can be deposited either in cash or in unencumbered security -or in both. Besides, they have to deposit 20 percent of their profit for each year earned from the business in India with the Reserve Bank of India. In case, the foreign bank closes down its

business in India, these deposits will be used for meeting the liability of the Bank, in India.'

Sub-section 3 of the Section 11 deals with the paid-up capital and reserves of Indian banks. It lays-down that minimum capital and reserve Should be Rs. 5 lacs for businesses in more than 1 state, and, if it also operates in Bombay, Calcutta or both, Rs. 10 lacs.

If the business is confined to just 1 state and does not include Bombay and Calcutta, capital can be just Rs. 1 lacs for its each place of business + Rs. 10,000/- for each Of its other place of business ' at the same district + Rs. 25,000/- for each place of business situated elsewhere in the state (the total not exceeding Rs. 5 lacs). However, for the companies opened after enactment of the act, the paid up capital has to be a minimum Rs. 5 lacs.[2]

- **Minimum reserve required by law**

Banking Company Incorporated in India Aggregate Value of Paid-up

(i) If it has places of business in more than one state	Rs. 5 lacs
(ii) If any such place/places of business is/are situated in Mumbai or Calcutta or both	Rs. 10 lacs
(iii) If it has all its places of business in one state none of which is situated in the city of Mumbai or Calcutta :	
(a) In respect of its principal place of business plus	Rs. I lac
(b) In respect of each of its other places of Business Rs.10, 000 plus situated in the district of principal business	
(c) In respect of each place of business situated elsewhere in the state outside the same district Subject to a total of	Rs. 25,000 Rs. 5 lacs
(iv) If it has only one place of business	Rs. 56,000
(v) If it has all its places of business in one state, one or more of which is or are situated in the city of Mumbai or Calcutta in respect of each place of business situated outside the city of Mumbai or Calcutta subject to a total of	Rs. 25,000 Rs.10 lacs

The above-mentioned requirement relates to the value of paid-up capital and reserves of a banking company. The term- 'value' has been defined in Sub-section (5) so as to mean the 'real' or exchangeable value, and not the nominal value, *which may* be shown in the books of the banking company. The Sub-section also lays down that if a dispute arises in computing the aggregate value of the paid-up capital and reserve of any banking company, the determination of the name by Reserve Bank shall be final for the purpose of the Section.

The banking company can issue only ordinary shares and not preferential shares, except in cases where they were issued before 1st July, 1944.

As per Section 12(l) of -the Banking Regulation Act, 1949, the subscribed capital has to be minimum one half of the authorized capital, and paid up capital will be not less than one half of the subscribed capital. Even where the capital is increased, this requirement will have to be complied with.

- **Loans and advances:**

The banking system has to be very prudent in the management of credit portfolio, to ensure that every rupee lend/invested brings viable returns. The performance of the bank is therefore, primarily judged on the quality and viability of its advances. Therefore, loans and advances have to be on a sound basis and the funds invested profitably, ultimately keeping in view benefit of shareholders and the interests of depositors. The banks have at the same time to serve the legitimate credit needs of the community, for productive and other desirable purposes and also ensure that priority sectors and weaker sections are adequately financed as per the directions of the regulator, without diluting the credit appraisal standards.

In laying down the lending policy, consideration must be given to the individual bank's available financial resources, preferred market segmentation and secotral flows as also personnel capabilities, infrastructure facilities and organization set up attuned to expeditious dispensation of credit as also future growth potential. A Determination of who will receive credit and of what type, at what price and at which point of time must be made. Other internal factors to be considered include who will grant the credit, in what amount and what organization structure will be used to ensure compliance with the bank's own guidelines and procedure. As authority is delegated throughout the organization, the bank must have efficient systems for monitor ring

adherence to established guidelines. This can best be accomplished by an internal control and reporting system which adequately informs the Board/Senior management of how the polices are put in action and which also provided them with information sufficient to evaluate the performance of lower echelon officers and the conditions of the loan portfolio in relation to Credit Appraisal, Sanction, Monitoring and Follow-up.

- **General principles governing advances:**

Bank's ordinary business is lending using the deposits (public funds) mobilized from public, which involves taking risk. Credit risk is the major risk and banks' productivity, efficiency, and profitability, as also the overall soundness would depend on assessing the credit risk and expanding the credit portfolio. Appraisal of credit proposal requires understanding and identifying the nature of the risk, measuring the risk, monitoring the risk and finally managing the risk. Banks should have well-trained and experienced staff to efficiently handle the credit portfolio. Risk assessment techniques and management guidelines have to be formulated and put in place under continuous supervision and monitoring to ensure expansion of credit on sound lines. Expertise to understand sophisticated risk assessment models and acting on them without ignoring the basic principles of lending has to be developed. Sound lending policies and excellent appraisal standards will ensure good quality of advances, abinito minimum level of Non Performing Advances and higher levels of profit.

The discretionary powers to sanction are to be exercised by functionaries at different levels including the Chief Executive Officer and must be subjected to review by the next higher level in the organization. The reporting system should be such that the review takes place without delay. Exceeding the discretionary powers or undertaking unauthorized business should be discouraged. If required to be undertaken under exceptional circumstances in the larger interest of the bank, such action must be immediately reported to the appropriate authority for confirmation. Complete record of instructions/sanctions should be maintained. The supervisory system has to look into cases of abuse of discretionary powers. The business of lending money has an inherent business risk of some debts turning bad, thus causing loss to the lender. Losses cannot, be eliminated altogether, but can be minimized through an efficient and effective system of pre-sanction appraisal and post-sanction follow up.

➢ Different Kinds of loans:

The credit facilities generally advanced by the banks are classified broadly into Working Capital and Term Loans. This conventional classification has no relevance now. Now the banks have started extending loans to each and every purpose of the public. Apart from that a few banks have also started a scheme of `No purpose loan'. As far as a modern bank is concerned every purpose is a bankable purpose. The major areas where the banks extended their credit are as here under.

(a) Working Capital:-

Working Capital is the excess of current assets over current liabilities. Current assets are those assets are those assets which will be converted into cash within the current accounting period or within the next year as result of the ordinary operations of the business. They are cash or near cash resources. Those include:-

i) Cash and bank balance
ii) Inventory – Raw materials, Work-in-process, Finished Goods
iii) Receivable
iv) Prepaid expenses
v) Short term advances
vi) Temporary investment

Current liabilities are the debts of the firms that have to be paid during the current accounting period or within a year. These include:-

i) Creditors for good purchased
ii) Outstanding expenses due but not paid
iii) Short term borrowings;
iv) Advance received against sales
v) Taxes and dividends payable
vi) Other liabilities maturing within a year.

Working capital is also known as circulating capital, fluctuating capital and revolving capital. The magnitude and composition keep on changing continuously in the course of business.

Generally the working capital has its significance in two prospective - `Gross working capital' and `Net working capital', refers to the firm's investment in current assets. The term `Net Working Capital' refers to the excess of current assets over current liabilities. These gross working capital and net working capital are called Balance Sheet approach of working capital.

(b)Term loan:-

Term loans are the facilities granted by the banks for a fixed period. It could be long term or short term. The short term loans include finances on small and the medium project here as the long term loans relate to infrastructural projects. One of the major areas of term loan in recent years is the Housing Loans. In India, growth of hosing finance segment has accelerated in recent years. Several supporting policy measures (like tax benefits) and the supervisory incentives instituted had played a major role in this market.

Housing credit has increased substantially over last few years, but from a very low base. During the period 1993-2004, outstanding Housing loans by scheduled commercial banks and housing finance companies grew at a trend rate of 23 per cent. Recent data reveal the non-priority sector housing loans outstanding as on February 18, 2005 were around Rs. 74 thousand crore. Direct housing loans up to Rs. 15 lakh irrespective of the location now qualify as priority sector lending.

(c)Retail/Consumer Credit:-

The issue of retail consumer credit is extremely important and topical. Banks are awash with liquidity. Prime corporate do not borrow from banks, except at sub PLR rates. There are no longer any regulatory hurdles. Consumer goods, which in turn helps the manufactures. Consumer credit has been a spectacular innovation in the commercial banking sector in recent years. The growth of retail lending, is attributable to the rapid changes in the evolving macroeconomic environment, financial market reform, and several micro-level demand and supply side factors.

Retail loan is estimated to have accounted for nearly one-fifth of all bank credit. Housing sector is experiencing a boom in its credit. The retail loan market has decisively got transformed from a sellers market to a buyers market. Gone are the days where getting a retail loan was somewhat cumbersome. All these emphasize the momentum that retail banking is experiencing in the Indian economy in recent years.

The typical products offered in the Indian retail advances segment are housing loans, consumption loans for purchase of durables, auto loans, credit cards and educational loans. The loans are marketed under attractive brand names to differentiate the products offered by different banks. The loan values of this retail lending typically range between Rs.20, 000 to Rs.100 lakh. The loans are generally for duration of five to seven years with housing loans granted for a longer duration of 15 years.

(d)Foreign Trade Finance:-

It is popularly known as export finance. It is extended in two legs namely:-

(1) Pre shipment &
(2) post shipment finance

(1)Pre shipment Finance (PCL):-

Pre shipment (Packing) credit loan is a working capital advance granted to the Exporter for financing purchase of raw material, processing and packing of the goods on the strength of letters of credit or Firm Orders established in favour of the Exporter.

P.C.L. can be granted by way individual accounts wherein packing credit/s against each LC/Firm Order are shown separately in the register and proceeds of the relative export bills under a LC/Firm Order will go towards liquidating the individual packing credit/s relating to the same LC/Firm Order.

From 14th March, 1992, banks are also authorized to grant PCl under the `Running Account' facility, without insisting

on prior lodgment of LC/Firm Order. In a Running Accounts facility, PCLs are granted on a continuous basis and are not marked against any particular LC/Firm order. Realization of the PCL takes place on the basis of the First in First out (F I F O) principal i.e. the first PCl is realized out of the proceeds of the first export bill. The account will operate more or less like an overdraft facility. However, care should be taken to have a system which will monitor the receipt of LCs/Firm Orders after a reasonable period from the date of extending the PCs, the future orders on hand and the shipments have already been executed. This will ensure that the continuity of business and receipt of orders is there, to justify the extension of the `Running Account' facility. Normally the running account facility is extended taking into account the following:-

(1) The need for the running account facility has been explained and justified by the Exporter to the satisfaction of the Bank.
(2) Running Account Facility will be extended only to those exporters whose track record has been good.
(3) As stated earlier LCs/Firm Orders should be produced within a reasonable time.

Procuring raw materials/purchasing/manufacturing/ processing/transporting/warehousing/packing and shipping of the goods.

Packing Credits will have different nomenclatures depending upon the purpose, security, state of the advances etc. For instance when PCs are granted on a clean basis which will result in procurement of raw materials/inventory at a letter stage it is called PCL (Clean), when the goods arrive and are hypothecated to the bank the PCL (Clean) gets converted into PCL (Hypothecation) gets converted into PCL (Pledge) and when the good are duly packed and are in the process of being shipped the PCL (Pledge) will become converted into shipping Loan.

(2)Post shipment Finance:-

Post shipment finance can be in the form of:-

1. Negotiation/Payment/Acceptance of export documents under Letter of Credit.
2. Purchase/Discount of export document under Confirmed orders/export contracts etc.
3. Advances against export bills sent on collection.
4. Advances against export on consignment basis.
5. Advances against undrawn balance on exports.
6. Advances against receivables from Govt of India.

Major exchange control regulations -

1. Exporter should have I E Code No. and each shipment should be accompanied by the relevant export declaration from (GR/SDF/PP/SOFTEX) from in which the value of the export will be declared and duly certified by the Customers authorities.

2. Shipping Documents along with the relevant export declaration form should be submitted to the AD within 21 days from the date of shipment. If the delay for submission is genuine, AD can condone the delay and accept the documents even after 21 days.

3. payment should be received in an approved manner within the prescribed time.

Post shipment finance is basically financing against export receivable after the date of shipment till the date of realization of the export bill. As the advance is granted against evidence of export shipment and the document of title to goods are handed over, the advance is normally self liquidating.

- **New concept of Bank lending:**

Before lending money a bank has to assess all-important factors that have a bearing on the financial soundness of the borrower, the prime focus being on the purpose and need of the credit and the ability of the borrower to repay the advances as per terms of the loan. The borrower's character, experience and competence to manage the business and to

utilize the funds for the purpose for which they are lent are normally taken into account. The project or activity proposed to be financed should be capable of generating sufficient surplus so that the loan is serviced and repaid. The quantum of advance (term loan and/or working capital) should also be sufficient to meet the genuine needs of the borrower in time. Lending either too little or too much in relation to need may cause problems.

An effective system to obtain the statements/reports regularly and scrutinize them is a necessary concomitant to sound lending. While disbursing loans, the banks have to ensure that all the required documentation is complete. Banks have a tendency to be complacent in these matters because of familiarity with the borrowers or sometimes even lack of properly trained staff. Ineffective internal audit and supervision also contribute to the laxity and ultimately the borrowers take full advantage of lapses, causing the banks to suffer.

Apart from compliance with terms and conditions of sanction of the facility, the lending banks have to ensure end-use as also safety of funds lent. It is imperative for the banks to keep a close watch on the affairs of the borrowers throughout the currency of the advances so as to take appropriate remedial measures, in case the borrowers' ability to repay and to service the advances show signs of deterioration.

In a highly cut-throat competitive environment, banks are chary of exchanging credit information while granting credit facilities to the borrowers, their associates and sister concerns. The quantum of credit availed by various units, purpose for which credit is granted, end use of funds, etc. are not generally made transparent and shared among the lenders and with the result some groups of borrowers circumvent the credit discipline by establishment of several smaller concerns and avail large funds from different units of the banking system for the ultimate benefit of their parent company. Banks, while granting credit facilities afresh or extending additional facility to any units belonging to a particular group are invariably required to make enquiries and satisfy themselves about the conduct of the companies in the group, with different banks. This is often not complied with for fear of loss of business. Such lapses result in the over drawal of credit or excessive credit without the backing of adequate securities.

Non-observance of laid down credit norms and policy has often led to serious problems for banks loans sanctioned. Major sources and causes of failure of loans include.

(i) Connected Lending:- Although BR Act restricts connected lending, there are a significant number of problem credits in the form of over-extension of credit made on unsound basis to directors or large share holders, or to their interests, to obtain funds in the form of unjustified loans. The management often vigorously defends such unsound loans. In a connected lending, both the sources and the cause of the problem originate within the bank. The observations made by Sri. Venkitaramanan in regard to the melody of connected lending are significant. The Indian public banking system is a miraculous, money machine. It is not an exaggeration to say that we see here cardinal sin of connected lending, which occurs whenever the owner of a bank takes loans from the deposits it raises.

(ii) Anxiety for Income:- the loan portfolio of a bank is usually the most important revenue-producing asset. The earnings factor, however, must never be permitted to outweigh that of soundness so that credits that carry undue risks or unsatisfactory repayment terms are not encouraged. Unsound loans usually result in cost, which are far more than the revenue produced.

(iii) Compromise of Credit Principles:- Bank managements, for various reasons, may grant loans carrying undue risks or unsatisfactory terms, knowing fully well the violation of sound credit principles involved. The reasons for compromise on basis credit principles may include, deposit oriented advances, loans under political pressure/influence, evergreening of advances to cover up the lapses, familiarity lending and competitive pressures.

(iv) Inadequate Credit Information:- Complete credit information is the only acceptable and reasonably accurate method for assessing a borrower's integrity and financial capacity. Character, competence and credit worthiness should be subject to review at periodical intervals through market intelligence. The lack of supporting credit information like availability of reliable financial statements and other statistical data is often an important cause of problem credits. Other essential information regarding purpose of the borrowing, the intended

plan and source of repayment, progress reports, inspections and memoranda of outside information and loan conferences, should be available on record and factored into credit appraisal and proper credit administration.

(v) Failure to Comply with Terms and Conditions Attached to the Loans Repayment:- Loans released without a clear agreement governing repayment are in violation of fundamental banking principles. Such loans turn sticky. More common (and generally as bad) is the case where the bank has an agreement with the borrower regarding the repayment or progressive liquidation of his loan but fails to collect the principal payments when due and in the manner laid down. A study of loan losses will show that, in many cases, amortization never equaled the repayments of principal the borrower agreed to make. It is sound axiom that good lending and good borrowing both require regular liquidation.

(vi) Familiarity and Complacency:- Banks often tend to be complacent and fail to effectively supervise the loan accounts particularly relating to familiar and long time borrowers. Even if some signals are received about such borrower or his business, banks often ignore to take cognizance of the information and extend undue support with or without the knowledge of internal supervisory authorities.
Many loans that are sound at inception have developed problems and resulted in losses, because of lack of effective supervision and follow-up. Ineffective supervision is also invariably the result of a lack of knowledge of the borrower's affairs over the lifetime of the loan.

(vii) Lack of Expertise and Technical Incompetence:- Professionalism in the approach to credit sanctioning has been found wanting. Lack of proper analysis of financial statements and not obtaining and evaluating other credit information, often leads to loan losses.

Modern system of lending requires a proper analysis of balance sheet. A model analysis is given hereunder.

STRUCTURE AND ANALYSIS OF BALANCE SHEET

BALANCE SHEET	**SCHEDULES**
Liabilities/Sources of Funds	

Share Holders Funds Share Capital----------------------------	Authorized / Issued / Subscribed / Called up Capital **Paid Up Capital** Equity Share Capital Redeemable Preference Share Capital
Share Application Money	-- -- -- -- -- -- -- -- --
Reserves and Surplus	General Reserve Capital Reserve Share /Securities Premium Account Investment Fluctuation Reserve Revaluation Reserve Credit Balance in Profit and Loss Account.
. **Loan Funds** Secured Loans Unsecured Loans	
. IFST Deferral/Deferred Tax Liability	--
Total Funds Employed / Total	

Liabilities	
Application of Funds/ Assets.	
1. Fixed Assets Gross Block Less: Depreciation Net Block + Capital Works in Progress	Fixed assets are grouped as Land, Building, Plant & Machinery, Furniture & Fixtures, Vehicles, Office equipments etc and the gross and depreciated value of each group are shown
1. Investments	Govt. Securities Long Term Trade Quoted Investments Unquoted Shares Bonds
3. Current Assets Loans & Advances Inventories Sundry Debtors/Receivables Loans and Advances	Raw material Work in Progress Finished Products Goods in Transit Stores/Spares/Consumables. Debtors outstanding for more than 6 months of which Considered Good Considered Doubtful Provision for Doubtful Debts Balance + Other Debtors considered good Bills receivable Advances Recoverable in Cash or kind for value received Advance Tax Payments etc Cash in Hand

Cash & Bank Balances	Balance with Banks Fixed Deposit with Banks.
Less Current Liabilities & Provisions Current Liabilities	Sundry Creditors Bills Payable Other Creditors Outstanding Expenses Provision for taxation Dividend etc.
Provisions. Net Current Assets	
4. **Miscellaneous Expenses**	Goodwill, Patents etc Preliminary and Preoperative Expenses Deferred Revenue Expenses Debit Balance in Profit & Loss account.
Total Assets.	

Other Points:

1. Read Auditors Report and Note to accounts carefully and ensure there are no major adverse comments. Obtain clarification wherever necessary and incorporate in the appraisal note.
2. Analyze the contingent liabilities reported in the notes to accounts and incorporate major adverse impact, if any, on the financials of the company in the appraisal note.
3. Tangible Net worth (TNW) is Capital PLUS Reserves other than Revaluation Reserves MINUS - Intangible Assets.
4. Net Working Capital (TNW) is the contribution from Long Term Sources to Working Capital Requirements (Current Assets).ie. Long Term Liabilities MINUS All Assets other than Current Assets. Or Current Assets MINUS Current Liabilities

Profit & Loss Account- Structure & Analysis

1. Sales/Income
- Sales – Income from Operations
- Other Income
- Stock adjustments

2. Expenditure
- Cost of Goods Sold- Raw Material Consumed and other Direct Expenses
- Sales & Administrative Expenses
- Financial Charges
- Depreciation

3. Profit before Taxation
- Taxation

4. Net Profit after Tax +
Balance B/F from Previous Year

5. Total Profit available for Appropriation
- Dividend
- Dividend Tax
- Transfer to Various Reserves
- Balance Transferred to Balance Sheet

(See Schedules to P&L Account for income/expenditure included under various heads)

Analysis of Profit and Loss Account

- Analyze major variation, if any, in each head & obtain clarification wherever necessary.
- Read Notes to P&L account and Analyze comments of auditors affecting net profit such as -
- Changes effected during the period in the method of accounting Income and Expenditure
- Changes in the Method of Calculating Depreciation
- Statutory dues/Employees' benefits etc not provided for
- Transfer from Reserves to Profit and Loss Account.

Assess the total impact of such comments on the working result – obtain clarification wherever necessary- Have considered opinion on the profitability of the unit - mention your observation in the appraisal note where ever necessary.

Some important figures from P&L A/c required for appraisal of the proposal /credit rating

- Sales/ Income from Operation
- Other Income
- Cost of goods consumed
- Net Profit after Tax
- Depreciation
- Interest on Term Loan & Working Capital
- Tax
- Cash Profit - Net Profit After Tax Plus Depreciation
- PBIT- Profit Before Interest and Taxes
- PBDIT-Profit before Interest Depreciation and Tax

Ratio Analysis & Credit Rating Assessment on Financial Parameters

Financial Ratios

Debt Equity Ratio

- With out Quasi Equity'

$$\frac{\text{Total Outside Liabilities (TOL)}}{\text{Tangible Net Worth (TNW)}}$$

Low Risk	Moderate Risk	High Risk	Very High Risk
Less than 2.00	2.00 to less than 3.00	3.00 to less than 4.00	4.00 and above

- With Quasi Equity

$$\frac{\text{Total Outside Liabilities other than Quasi Equity}}{\text{Tangible Net Worth+ Quasi Equity}}$$

Low Risk	Moderate Risk	High Risk	Very High Risk
Less than 1.50	1.50 to less than 2.00	2.00 to less than 3.00	3.00 and above

Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Low Risk	Moderate Risk	High Risk	Very High Risk
1.33 and above	1.25 and above but less than 1.33	1.10 and above but less than 1.25	Less than 1.10

Percentage of TNW invested in Associate Concerns

$$\frac{\text{Investments in Associate Concerns x 100}}{\text{Tangible Net Worth}}$$

Performance Ratios

Rate of Growth in Sales or Gross Income – (%)

$$\frac{\text{(Sales of a year minus Sales of Previous Year) x100}}{\text{Sales of Previous Year}}$$

Low Risk	Moderate Risk	High Risk	Very High Risk
20% and above	10% and above but less than 20%	5% and above but less than 10%	Less than 5%

Net Profit to Sales-(%)

$$\frac{\text{Net Profit after Tax x 100}}{\text{Net Sales}}$$

General

Low Risk	Moderate Risk	High Risk	Very High Risk
4% and above	2.50% and above but less than 4.00%	Less than 2.50%	Loss

Traders

Low Risk	Moderate Risk	High Risk	Very High Risk
Above 5.00%	More than 2.00% up to 5.00%	More than 1.00% up to 2.00%	1.00% and below

Cash Profit Ratio-(%)

$$\frac{\text{Cash Profit x100}}{\text{Net Sales}}$$

Low Risk	Moderate Risk	High Risk	Very High Risk
12.00% and above	5.00% and above but less than 12.00%	Less than 5.00%	Loss

Interest Service Coverage Ratio (No. of Times)

$$\frac{\text{Profit before Interest, Depreciation and Tax}}{\text{Interest}}$$

General

Low Risk	Moderate Risk	High Risk	Very High Risk
More than 4.00	More than 3.00 up to 4	More than 2.50 up to 3.00	2.50 and below

Traders

Low Risk	Moderate Risk	High Risk	Very High Risk
More than 4.00	More than 3.00 up to 4.00	More than 2.00 up to 3.00	2.00 and below

Inventory+ Receivables/ Sales (No. of Days)

$$\frac{\text{(Inventory + Receivables) x 365}}{\text{Sales}}$$

Low Risk	Moderate Risk	High Risk	Very High Risk
Less than 90 days	90 days and above but less than 120 days	120 days and above but less than 180 days	180 days and above

Return on Capital Employed (%)

Profit Before **Interest*** and Tax x100
Capital Employed

*Interest, if any, paid on the Capital.

Low Risk	Moderate Risk	High Risk	Very High Risk
15.00% and above	5.00% and above but less than 15.00%	Less than 5.00%	Loss

Sales to Fixed Assets (No. of Times)

Sales
Fixed Assets

Low Risk	Moderate Risk	High Risk	Very High Risk
4.00 and above	2.00 and above but less than 4.00	1.00 and above but less than 2.00	Less than 1.00

Gross Profit Ratio (%)

Gross Profitx100
Sales

Rate of Growth in Gross Profit (%)

(Gross Profit of the year minus Gross Profit of Previous Year) x100
Gross Profit of Previous Year

Low Risk	Moderate Risk	High Risk	Very High Risk
20.00% and above	10.00% and above but less than 20.00%	5.00% and above but less than 10.00%	Less than 5.00%

Debt Service Coverage Ratio (DSCR)- No. of Times

Net Profit after Tax + Depreciation +Interest on Term Loan
Yearly Installment & Interest of Term Loan (Yearly Repayment Commitment)

Low Risk	Moderate Risk	High Risk	Very High Risk
1.75 and above	1.60 and above but less tan 1.75	1.50 and above but less than 1.60	Less than 1.50

Turn Over Ratio

Inventory Turnover Ratio (No. of Times)

Sales
Inventory

Receivables (No. of Days) – Debtors Velocity

Sundry Debtors x 365

Sales

Creditors (No. of Days) -Creditors Velocity.

Creditorsx365
Purchases

Assessment of Credit requirements

There are mainly 3 methods for assessing the credit requirements

1. Turn Over Method for Credit Limits up-to Rs.5.00 Crore
2. IInd method of Lending for Credit Limits above 5.00 Crore
3. Cash Flow Method.

Turn over Method:

Under this Method the Working Capital Requirement is assessed based on the PROJECTED SALES TURNOVER (PST). Therefore we have to ensure that the sales turnover projected by the applicant is realistic, based on past trend and attainable. If the PST is not based on past trend, the reason for giving such a high projection should be ascertained. The acceptance of the projection must be subject to convincing reason - other wise the projection has to be reworked and reduced to an acceptable/attainable level. Once the projection is accepted the credit requirement is to be calculated as follows:

Working Capital Requirement: 25% of PST
Minimum Margin: 05% of PST
Bank Finance: 20.00 % of PST

DP can be regulated taking usual safeguards, level of Current Assets etc. This method may not be suitable to industries having long processing time. If the requirement under traditional method is more than the eligible Bank Finance under Turnover Method limit may be sanctioned under traditional method.

Second Method of Lending:

Under this method credit requirement is calculated based on the level of current assets and liabilities. It is to be ensured that the unit is not holding stock more than the required level and that non current assets are not included in the current assets.
Under this method the minimum margin (NWC) is 25% of the current assets. No margin is required for Export Receivables and LC bills discounting. If bills discounted with banks are treated as contingent liability and not included in the assets and liabilities disclosed in the balance sheet, this amount should be added back with receivables and

bank borrowing for working capital while analyzing balance sheet and calculating the credit requirements

- **Method of Calculation**

A. Total Current Assets
B. Less Current Liabilities Other than Bank Borrowings
C. Working Capital Gap- WCG (A-B)
D. Minimum Margin (Minimum NWC) - 25% of Current Assets Excluding Export Receivables & LC Bills Discounted
E. Actual NWC (Current Assets minus Current Liabilities including Bank Finance)
F. C minus D – ie. Working Capital Gap minus Minimum Margin (Minimum NWC)
G. C minus E- ie Working Capital Gap minus Actual NWC
H. MPBF- F or G whichever is less.

(No margin requirement for LC bills Discounting)

- ***Cash Flow Method.***

For Seasonal Industries, finance under MPBF worked out as per the above two methods may not be sufficient.

In such cases their peak level requirement may be assessed and monthly permissible bank finance may be calculated based on cash flow/ cash budget.

Deciding Nature of Facility:-

MPBF is calculated based on total current assets and current liabilities. It may not be possible to create charge on some of the current assets - eg. Loans and Advances, Pre-paid Expenses, etc.

So the nature, amount and margin of credit facilities have to be decided based on the nature and amount of chargeable current assets like Inventory, Receivables etc.

Pre sale working Capital Facility:-

Credit limits like Packing Credit, ODH, ODP etc sanctioned against the pledge/hypothecation of inventory are pre sale working capital limit. **Overdraft on Book Debts and Bill Discounting facility** sanctioned against Receivables are Post Sale Working Capital Limit.

For ODBD facility we generally insist 50% margin and Debtors not older than 90 days only are accepted as security.
Margin has to be fixed based on the value of security asset and limit sanctioned, subject to minimum stipulations.

Grant of loans towards working capital, without having any relevance to the equity investment of the borrower, his net worth and repaying capacity, without ensuring end-use of funds lent, etc., result in the funds becoming difficult to recover. The concern for recovery also lays down emphasis on properly securing the loan portfolio. The main modes of security by banks are discussed hereunder.

➢ **Secured loans:-**

There are many customers of a bank, who, are not so well placed and whose financial responsibility or income is not sufficiently strong to justify unsecured credit, or the amount of the credit the borrower would like to obtain is out of proportion to his net worth. It is usual for borrowers in this category to strengthen their credit obligations by judgment of some approved tangible security to support the loan. The bank may sell in the event of the borrower failing to pay his loan at the appointed time. We have, therefore, the collateral loan. AM in the latter case, it is not the borrower's credit that is the pivotal point, but the quality of the collateral.3 The question of security of loans are discussed below:-

Loans are secured for several reasons:-

1. The financial condition of the applicant for loan is not strong enough to justify an advance without security.
2. Some customers would borrow on a collateral basis rather than divulge to the bank their financial condition.
3. The borrower may feel that he has an obligation to honor and he may be forced to reply the loan.
4. Sometimes a security is furnished so that more favorable rate of interest may be obtained by the borrower.

➢ **Unsecured Loan:-**

An unsecured loan is granted by the bank after consideration has been given to the credit standing of the applicant and after the bank has been satisfied that the prospective borrower will be able to make repayment of the lo9an in a reasonable period of time which is usually determined at the time the loan is sanctioned. In

the case of unsecured advances the banker relies on the personal goodwill of his customer while his security depends upon the present condition and future prospects of the business of the borrower.[2]

In the USA, a large proportion of the loans made by commercial banks are unsecured. The American banks lend either for the manufacture or for the purchase of merchandise and the banks are repaid when the merchandise is sold.
In Great Britain, advances against the personal securities of the borrower supported by a guarantee are common and the experience of English banks in such types of advances has not been unsatisfactory.

In India however, unsecured advances constitutes not a large proportion of the advances made by banks. In the minds of Indian bankers, there has always existed a bias against unsecured advances and, therefore, they hesitate to run risks to any large extent. Even the Reserve bank of India has not favored clean advances to businessman enjoying cash credit limits against certain controlled commodities.[3]

In considering applications for clean advances the banker must satisfy himself:

(a) that the purpose for which the loan is required is likely to be remunerative and the product readily saleable,
(b) that the amount and period of the loan applied for and time of the application are appropriate to the purpose,
(c) that the applicant understands his business and the co-obligates, if any, are credit-worthily,
(d) that he has sufficient resources of his own for the expansion of the business and is not over-trading,
(e) that he owns sufficient landed and immovable property in the locality where he carries on business,
(f) that the applicant has no speculative tendencies and is reported to be a good pay master, and
(g) that the borrower will be able to return the money in short period and the loan will be able to return the money in short period and the loan will be used for genuine trade purpose.

In addition to the points mentioned above, the banker should satisfy himself on the following points:

(a) that the borrower has the legal capacity,

(b) if the borrowing is sought by an agent on behalf of his principal the agent has authority in the matter, and
(c) the purpose of the loan is within the terms of the Government's current credit policy as expressed in Reserve Bank's directive issued to banks from time to time.

One of the most important considerations in every advance is the position of the borrower, it is particularly important in the case of the unsecured advance. A banker requires security as a protection against unexpected default in the payment by the customers.[1]

> When a bank obtains a promote from a client whether single or joint, he is not obtaining any more than a promise from the client to the effect that he will make repayment on a given date, and the bank has to trust in the good faith of such client.[2]

➢ **Special Banking Services:-**

Over the centuries, banking has evolved by deftly adopting to the needs of the time. The course of banking history from Lombardy to London is replete with instances of its willingness and ability to cope with new developments in the environment. One such coping strength of banking is its acceptance of automation in full measure.

Banks are not islands. They are an integral part of the society they serve. Consequently, banks in advanced countries are complex organization characterized by highly advanced countries are complex financial systems, very much a replica of advanced economic. Of necessity, banks respond to demands made on them together, process, analyze, financial information contained in trillions of data every day and make quick decisions. Banking is almost a daily necessity for a vast majority of any industrially developed society. The need for highly efficient, flawlessly effective, extremely fast (in most cases, instant real time money movements), and reasonable priced banking service can be met only through automation of banking operations.[2]

The sheer volume of transactions, the time value of money in wholesale banking (where the smallest unit may be US S 1 million) and the analysis of lending proposals of giant corporations based on applications of quantitative methods-all point to only one direction, i.e., automation of banks.

1. *Ibid, p. 105.*
2. *Ibid.*

Banks have successfully used computers, micro electronics and telecommunication, to store, analyze and retrieve financial information in the form of pictures, words, impulses and digits, representing money Telecommunications, to store, analyze and retrieve financial information in the form of pictures, words, impulses and digits, representing money or information relating to money, more reliably, quickly and economically.

The automation in the thirties was confined to adding machines and simple cash dispensers. The real computers were introduced in banks in the fifties and sixties. By the mid-sixties, almost all banks in developed countries had moved into the computer- banking era. *Decimalization* of currencies in most of the developed countries further accelerated the process of automation. Leading banks introduced on-line branch terminals-linked to their mainframe-instead of off-line terminals.[3]

In terms of technological process, initial automation was essentially mechanical. Over the decades, it graduated to electrical devices. The third stage is that of electronic banking.

Automation in banks in advanced countries is omnipresent- be it retail banking (Personal market segment) or wholesale banking:- be it acceptance of deposits or direct debits and payments. Computerization of accounts is not confined to large corporation borrowers or depositors. Today, it covers small business, wage earner and no-so-simple transactions like establishing letters of credit, syndication of loans, Euro Currency lending's, investment banking, futures and options in forex business.

Cash dispensers popularly known as automated teller machines (ATMs) are the commonest and apparent manifestation of highly advanced automation in banks today. Using ATM, customers can withdraw specified amounts in cash from these machines round the clock. These machines have been installed outside the branch premises or at convenient public places. In some countries, the banks' customers can ascertain the balance and entries in their accounts, which are displayed in the visual display screen.

In collaboration with telephones and telecommunication authorities, some banks have introduced new telecast communication systems, called 'Videotext'. Through this system, member banks offer to their constituents, through the use of their (Customers') telephone and/or

3. See. **Suneja, p.** *122.*

television screen, real time information on money and investments, securities, loans and other banking services. Customers, by linking this 'Videotext' to the bank's computer, can find out the balances and details in their account.

P.O.S. or 'Point of Sale' is yet another milestone in automation of personal segment banking. Bank customers while retail shopping at chain stores, supermarkets and petrol pumps, etc. need not pay cash or give cheques for goods and services purchased. All they need to do is to authorize an electronic transfer of the purchase amount from their (buyers') bank account to the sellers' banks account.

During the sixties, in the United Kingdom, introduction of M.I.S.R. (Magnetic Ink Character Recognition) on cheques helped a great deal in sorting out cheques in clearing. For credit vouchers, O.C.R. (Optical Character Recognition) was successfully used. Later, many countries the world over adopted these applications.'

B.A.C.S. (Bankers Automated Clearing Services) enabled bankers to settle their clearing transactions without recourse to papers and vouchers. At present, B.A.C.S. cover transactions like salary credits, bill payments, standing orders, direct debits, payment of insurance premia, rates subscription and mortgage repayments, etc.'

C.H.P.S. (Clearing House Auto Payment System) provides the facility of same day clearance in the banks. S.W.I.F.T. (Society for Worldwide Interbank Financial Telecommunication) system provides the unique facility of real time instant transfer of funds among a vast number of banks spread all over the world.'

V.D.U. (Visual Display Units) has revolutionized the decision- making process and capabilities of the bankers in developed countries. Foreign exchange dealers can, at a push of a button, see on their V.D.U. screen, foreign exchange spot and forward rates in different time zones, as far apart as London, New York, Tokyo, Frankfurt, Zurich, Singapore, Hong Kong, Bahrain or any other major financial nerve centre. Likewise, an investment banker, a lending banker or for that matter a merchant banker can call on the screen verified data, -comparative information, analyzed conclusions and programmed appraisals.

Automation in assets, funds and cash management of large corporate borrowers, depositors and investors is yet another steps forward: Computers now constantly process and analyze the flow of funds, yields assessment and comparative risk analysis; automatically withdraw the

lowest yielding securities below a pre-determined cut-off point, transfer inventible released amounts to portfolio above an acceptable level of risk and/or return.

All kinds of memory cards have taken banking by storm. The plastic cards with indelible or crossable memory along with their microprocessors, have enabled banks to pay their customers pre-determined and allocated amounts against revolving limits or pay amounts against prepaid amounts, Euro-card, Master Charge (U.S. Credit Card), Access (British Credit Card), are few examples of extremely successful applications of this concept.'

The growth of technology has changed the payment systems world over during past decades. The introduction of Automatic Teller Machines has given facility to the bank customers for banking beyond the banking hours.

An ATM is a device located on or off the bank's premises to receive and dispense cash round the clock. Customers can also use ATMs for depositing cash, chèques, obtaining balance, obtaining statement of last few transactions in his account, requesting cheques books, and payment of card bills and for transferring funds from one account to another.

A customer who wishes to utilize the service of ATMs will have access to it only with an ATM card. The ATM card consists of a personal identification number (PIN), which is known only to the customer: A customer who wishes to transact through the ATM will have to place the ATM card in the slot before starting his operation and he will be able to transact his business through interactive visual display unit and the keyboard.[2]

There are two types of ATMs: (1) Exterior ATMs and (2) Interior ATMs -Exterior ATMs are located in various places like shopping centers, airports, railway stations with or without drive in facility, while the interior ATMs are located within the bank premises. ATMs, which are directly interactive with the Bank's Computers, are known as on-line ATMs and the others are known as off-line ATMs. On-line ATMs require the support of effective telecommunication facility.

In some foreign Bank's ATMs the conversion of currency is also possible. Interactive and voice recognizer ATMs are also installed to facilitate the customers to interface in multi-language.[3]
The Internet is a global network of networks. It is a conglomeration of

1. *Ibid.*
2. *Introduction to Comiputer, The Indian Institute of Bankers, (1998), p. 189.*

smaller networks and other connected machines. Internet allows information about almost every topic, be it books, encyclopedias, countries, people, organizations, etc. In short, it is a system of smaller networks and other connected machines. Internet allows information about almost every topic, be it books, encyclopedias, countries, people, organizations, etc. In short, it is a system of computers, which allow user Computers the exchange of data, message, files, etc. with any of the millions of computer the world over having connectivity to Internet.

Internet has been around in different forms since late 1960s. Its precursor ARPANET was originally designed by the U.S. Department of Defense, in association with universities and research facilities. Initially, ARPANET was used mainly for communication technology related research and development, with scientists at various sites all over the world using this network to share their information. Through the next two decades it evolved into several other networks mainly used for military purposes. In 1989, these networks created for military purposes were dismantled and were replaced by NSFNET, the network of National Science Foundation and the infrastructure for these networks was made available to public at large. Now, the Internet is available around the globe to almost everybody. There are backbone computer networks, all over the world, which operate at very high speed and carry the bulk of the traffic. Other smaller networks are connected to these backbones systems. Therefore, Internet is not a physical place of brick and mortar but is an electronic link to the world of information through computers communicating with one another throughout the world.'

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The information on the Internet and the opportunities to use these are growing at a very fast rate. Last few years have witnessed phenomenal growth in its use. There were approximately 5, 00,000 computers or hosts connected to the Internet in 1990 which grew upto 4.8 million by 1995. At present about 60 million people are using it, which is expected 6 grow upto 300 million by the year 2002.

The VSNL has its main Internet Access Node at Mumbai. It is connected to the Internet Node at USA via Satellite Media. This Node is also connected to Internet Node in Europe via sub-marine Cable Media.

The VSNL Nodes at New Delhi, Calcutta, Chennai, Bangalore, Pune, Chandigarh, etc. are connected to the Internet Access Node at Mumbai through DOT provided inter-city links. The Internet Access Node of VSNL at Mumbai is also connected to VSNL's Gateway Switched Service (GPSS). Since, this GPSS is connected to Dot's. Remote Area Business Message Network (RABMIN), Domestic Packet Switched Network I-NET and high speed VSAT network. VNET, subscribers of all these networks also have an access to full range of Internet services.[2]

In addition to usual facilities like the electronic mail, Internet is a way which allows broadcasting information about organization/individuals, etc. It is a superb mode for disseminating information and allows easy access to the prospective customers.

With the use of specially created Web page (s), the banks can sell their products like Credit Cards, Home Loans, and their schemes; Internet saves a lot of money on long distance calls. It also helps in projecting an organization, improving public awareness about the products like some of the banks have been using it for propagating their Capital Issues. Essential information in areas like statement of policy, service information, etc. can be accessed by an employee on line from anywhere with the help of a simple browser. Interactive feedback forms can be designed and published over the web to gather customer information and feedback on various services.

Some of the banks are providing on-line account opening facilities to NRIs over the Internet. Recently, a new concept `Cyber banking emerged which refers to the payments through Cards engineered by purchasers/buyers of products/services over interest.[1]

➤ Smart Cards:-

Smart cards are prepaid cards giving entitlement to use of goods or services. Each time the card is used, the value of the goods or services received is decremented from the value on the card.

It is possible to combine all the above functions and offer an all-purpose card to the customer. It will be still more beneficial to the customers as well as the banks concerned, if banks in India choose to issue cards under a common banner, say, "INDIA CARD". One of the main reasons for the success of the NETS of Singapore was the coming together of the five major banks that dominated the domestic banking sector, which is worth emulating.[2]

The Smart Card looks exactly like, any other plastic card or an ATM card with an integrated circuit (IC Chip) installed. The IC contains memory, may contain a processor, and communicates with the external world through 4-5 contacts on the surface of the card. The size, position and utility of the contracts are specified by an international standard (ISO 7816), so that card can interact with a variety of equipment.

There are two main types of smart cards: Intelligent Memory Chip and microprocessor cards. Memory smart cards have been around for several years, being used in pay phones, identification, access control, voting, and other applications. There are used to store a value, which is *counted down until the card is exhausted and then thrown away. Recharging the card for reuse is not usually allowed, as then the financial security of the system may be compromised. The main security risk is from counterfeiting.

Processors smart cards are the most advanced, and are ideally suited for banking and financial applications where reuse of the card is allowed. These cards have a built-in memory and the processor; along with an operating system perform' the financial operations. As in the cards intelligence is built-in, they can protect themselves against fraudulent operations. This protection is based on the Data Encryption Standard (DES), which is accepted by the International Standard Organization as safe enough for protecting electronic funds transfer (EFT) transactions. For Smart Cards ISO 781.6 defines the physical -features and the communication protocols. **ISO 10202** defines the security features.

The card has space for several "electronic purses", each for the storage *of* an amount. These can be used for different types of accounts of the user. In addition there is space for -user data such as address, branch where the user has his account, and even the last 30 to 50 transactions.[3]

In India, the scope for the development of this advanced technology is vast because we do not have the telecommunications infrastructure to support it fully on-line system. In addition we do not have a large installed base of the_obsolete magnetic strip based ATMs and EFTPOS terminals that would force us to persist in using that technology.

➢ **Credit Card:-**

Generally, a bank enters into an agreement with its customer and issues the customer a credit card. A credit card is small plastic card around-8.5 cm. by 5.5 cm. It has the name and the account number of the holder embossed on it. In addition, the date up to which the card is valid will also be embossed and a specimen signature panel on the reverse. The card issuer should normally get the card holder to sign on the specimen signature panel in his presence before parting with the credit card. A card holder is also given the list of shops and reverse. The card issuer should normally get the card holder to sign on the specimen signature panel in his presence before parting with the credit card. A paper contains self-carbonizing chemicals. Imprinting serves two main card holder is also given the list of shops and establishments in each city where the card will be accepted in lieu of cash. The limit up to which the card holder can make purchases in a month is also informed to the card holder; this limit is called the card-limit. When a card holder purchases or uses the service of an ME, he or she gives the card to the shopkeeper at the time of payment. The ME verifies the card for validity date and then check the booklet called "Hot list Bulletin". This "Hot list Bulletin" consist of all cards which have been lost, stolen, surrendered by customer or invalidated by the issuer. If the card is not hot listed, the ME will proceed to make a bill for purchases made. Each ME has a limit below which he can accept payment without seeking "Authorization". Such a limit is called ME's floor limit. The floor limit varies from ME to ME depending on their nature and location of the business. However, the card holder need not know the floor limit, nor does the ME have to know the card holder's limit. If the transactions exceed the floor limit, the ME calls up the card issuer who may authorize the transaction or may not. If the card issuer refuses to authorize the transaction, the ME may advise the card holder of the refusal of the issuer and may accept only cash instead of the card. The reasons for authorization refusal may be because of having intimation of the card having been stolen or lost, or the total value of transaction exceeding the card limit, arrears or default in payment by card holder and so on.'

Once authorization is received, along with the authorization code, or if the transactions value is below floor limit, the Mc will prepare the credit card voucher called charge-slip, which is a detailed bill of the purchases

made or services availed. This voucher, which is in triplicate, win have to be signed by the card holder. When the signature is being taken on the vouchers, the ME will retain the card with him. This is to avoid forgery in case the card is stolen, since it is difficult even for a skilled forger without a copy of the signature in front of him. After the credit card voucher is signed, the ME should verify whether the 'signature on the panel matches with the signature on the voucher:

The ME can refuse to part with the goods if the signature does not tally. After it is signed the ME will part with the goods along with a copy of the charge-slip. The ME uses what is known as an imprinter. Imprinted means that the image is transferred to the paper by applying pressure and passing the roller over on the card with the paper below it. While the roller passes with pressure over the card, impression of the name and account number is transferred to the voucher. Although the charge-slip is in triplicate, no carbon paper needs to be used as one side of purposes-one to avoid the mistakes in writing the names and account numbers (usually 12 or 16 digit long) and the second is to ensure that the voucher is indeed prepared using a card and is not a fictitious

The credit card holder should be vigilant and take care to note that the ME does not prepare multiple vouchers, which can be misused later. This is possible since the signature of the card holder will be available on one of the vouchers, which can be used for forging signatures on the remaining vouchers.'

The ME will collect all the charge-slip and present it to the issuing bank, which after verification, will credit the ME's account or pay cash, depending on the agreement between them. The issuing bank will retain the original copy of the credit card voucher signed by the customer. At the end of the month all the credit card vouchers are accumulated and arranged branch wise, customer wise, and their accounts debited with the total amount of their credit card Vouchers. The customers are then informed of the debit and requested to deposit cash or credit their account in a specified time, generally 10 to 15 days. Generally, the task of collecting the credit card vouchers and informing the respective branches of the extent of the use of the credit card is done at a centralized department. This is because the credit cards can be used at MEs all over the country irrespective of which branch the customer has an account and issued him/her the credit card. The other reason is that for authorizing transactions above the floor limit, the authorizing department needs to have information at a central place so that it has the required information for taking an appropriate decision as an

1. Ibid.p.196

incorrect refusal can lead to serious repercussions on customer service. Many card issuers being banks also allow withdrawals of cash for emergency purposes and levy a service fee for such withdrawals ranging from 24 p.a. to 36 p.a. Many banks also have credit cards which double up as ATM cards, thereby offering the credit card holder the availability of cash 24 hours a day at a reasonable service charge, which can become very handy in case of emergency. There are different types of credit cards such as charge card, debit card, credit card, smart card or chip card and restricted card/member card.[2]

Use of Expert System:-

In the past few years, research in artificial intelligence has led to the development of "expert systems". An expert system is a high performance special-purpose system, which is produced by "capturing" and codifying the skill and knowledge of an expert using a computer language. The idea is that the resulting computer system can then provide the same level of service to a user as the original expert.

The most important component of an expert system is the knowledge-base (K-base), which contains all the "knowledge" in the domain used for making inferences. Waterman (1986) has pointed out that knowledge for an expert system can be acquired in several ways. One way is to adopt an observational approach, and analyze sources such as textbooks, examples and case studies. A second approach is to adopt an intuitive perspective, and have human experts analyze their own cognitive processes and derive a set of rules of thumb (or heuristics) for making decisions have human experts analyze their own cognitive processes and derive a set of rules of thumb (or heuristics) for making decisions.

There are problems in the implementation of each of these two approaches. The problem with the intuitive approach is its dependence on the expert to describe his or her knowledge in an easily understood manner. In practice, many experts make decisions based on intuition, and most of them find it difficult or impossible, to explain the decisions they make in a problem solving situation.

On the other hand, adopting an observational approach means that only a limited proportion of the problem space receives attention. This essentially means that other potential sources of expert knowledge are ignored. Even so, this approach does provide an accessible and easily codified source of decision rules that can form the basis from which more industry-specific expert systems can be developed. Industry-specific knowledge, usually in the form of heuristics, can be added to the K-base

of the general expert system so that the expert system constructed can be used to solve specific problems in the industry.'

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1. Toe, - A.A. Prolong- based expert system for price decision making under incomplete knowledge. In L.F. Pau, J. Motiwalla, Y.H. Pao,& H.H. Teh (Ede.), *Expert System in Economics, Banking and Management,* Amsterdam : North HoRand (1989), pp.

CHAPTER – III

MODES OF SECURING ADVANCES

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➢ Securing Advances:

In the employment of fund a banker generally attaches great significance to the consideration of security. There is a wide range of securities to cover bank loans and the major are goods and commodities, life policies, shares and stocks, title deeds of immovable properties and guarantees. Section 5 (n) of the Banking Regulation Act, 1949, provided that "a 'secured loan or advance' means a loan or advance made on the security of assets and market value of which is not less than the amount of such loan or advance; and 'unsecured loan or advance' means an advance not so secured". In case of secured advances, a charge is created over the assets of the borrower in favor of the banker. On the failure of the customer to pay back the loan or advance, the banker may, therefore, recover his dues from the customer out of the sale proceeds of the assets charged to him.

➢ Types of Securities:

There are different methods of creating a charge:

1. Banker's Lien;
2. Pledge;
3. Hypothecation; and
4. Mortgage

In each of thee cases the banker does not become absolute owner of the property; but has certain rights over the property until the debt due to him is repaid.

➢ Banker's Lien:

A lien is the right of a creditor in possession of goods, securities or any other assets belonging to the debtor to retain them until the debt is repaid, provided that there is no contract, express or implied, to the contrary. It is a right to retain possession of specific goods or securities or other movable of which the ownership vests in some other person and

the possession can be retained till the owner discharges the debtor obligation to the possessor.

So far the Indian Law is concerned there are no provisions in the Contract Act relating to lien and English law is to be applied on grounds of justice, equity and good conscience. A lien may be possessory, equitable or maritime.[1] Here we will focus our discussion on the possessory lien. Possessory lien may be either: (i) particular, or (ii) general.

Particular Lien

Particular lien arises from and is limited in its operation to, particular transaction in connection with the property subject to the lien. For example, we can say that the finder of a lost article has a right of lien on it until the owner compensates him for his trouble and expense of preserving it and for finding out the true owner. It this regard reference can also be made to section 168 of the Contract Act. Similarly, a jeweler entrusted with a diamond to cut the polish it has a right to retain it until the owner pays him for his services.[2] An unpaid seller of goods has a lien on them until the owner pays the price.[3] A particular lien is also called special lien. If I give my watch for repair, the repairer has the right to retain the watch till his charges are paid such type of lien exists only as a security for the particular debts incurred in respect of the watch itself. This type of right is generally enjoyed by the bailers, finder of goods, unpaid vendor, etc. on the other hand, if I give my cloth to the tailor for making a shirt for me, the tailor has a general lien on the cloth until his charges are paid.

General Lien

In a general lien the right to retain the goods will be available not only for the discharges overdue debt or liability incurred in connection with them, but also for a general balance of account arising out of similar transaction between the parties. For example a solicitor in possession of the title deeds of his client may retain it till his dues not only in respect of the deed itself but also with regard to the professional services rendered by him are paid.

In Alliance Bank of Shimla Ltd.,[4] the court held that general lien confers only on holder the right to retain the goods until the payment is made

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[1] Devendra Kumar v. Lal Chand, Gulab singh Nekhe Sing, AIR 1946 Nag. 114.
[2] The Indian Contract Act, Section 170.
[3] The Sales of Goods Act, Section 47.
[4] Alliance Bank of Shimla Ltd. v. Ghamandi Lal Gaini Lah. AIR 1927 Lah. 48

out but it does not carry with it the right of sale to secure the debt or indemnity. It is merely a right to retain goods or chattel and does not create right as in favor of a pledge. However, this is not the exhaustive definition of lien.

A general lien thus arises from a particular transaction and also relates to other and prior transaction of similar nature between the two parties and gives the creditor the right to retain against general balance of account, any goods bailed to him as a security. It is necessary that the goods or property subject to lien be owned by the debtor but the property in such goods or securities is not transferred to the creditor by lien. A general lien empowers the possessor to retain possession until the while one can say that a lien does not require any special agreement, written or oral, but it arises only by operation of law subject to the condition that the following requirements are fulfilled:[5]

- (i) that the creditor is in possession of the goods, securities, etc., and has come in possession thereof in the ordinary course of business;
- (ii) that the owner of the goods, securities, etc., has a lawful debt to pay to the person in possession thereof; and
- (iii) that there is no contract, express or implied, to the contrary.

A banker's lien is a general lien over a borrowing customer's property which has come into the banker's hand in the ordinary course of business. The general lien is conferred on the bankers under Section 171 of the Indian Contract Act, 1872 which provides:

"Bankers, factors, where fingers, attorneys of a High Court and policy brokers may, in the absence of a contract to the contract, retain, as a security for general balance of account, any goods bailed to them: but no other persons have a right to retain as a security for such balance, goods bailed to them, unless there is an express contract to that effect".

Under the above provision, no agreement is necessary to create a banker's line as such an agreement is implied so long as the same is not excluded expressly a banker's lien is more than a general lien. A general lien does not, as a rule, carry with it a right to dispose of the property. The general lien of a banker has been described as an implied pledge and for this reason he is generally regarded as having power to sell securities over which he has a lien. The power to sell can only be exercised by the

[5] S.N. Gupta, The Banking Law in Theory 7 Practice, (1993), p. 439 (hereinafter cited as Gupta)

banker when a customer has reasonable notice of the banker's intentions.[6]

As the general lien of the bank is recognized statutorily, no separate contract or agreement is required for this purpose. As a precautionary measure, however, banks obtain 'letter of lien' from their customers, stating that goods and securities are entrusted to the banker as security for the existing and future advances and authorizing the bank to sell them in case of default on the part of the customer. The letter spells out the object of the entrustment of the goods and securities to the banker so that the same may not deny by the customer later on.

- **Negative Lien:**

Under the negative line, the borrower gives a declaration to the banker that his assets mentioned therein are free from any charge or encumbrance and that he will not create any charge or dispose them of without the permission of the banker. The banker does not get the right to retain any assets of the borrower and cannot realize his dues from the said assets. His interests are, therefore, partly protected by a negative lien.

The banker's right of lien is not barred by the law of limitation. The effect of the Limitation Act is only to bar the remedy and not to discharge the debt. Consequently, it does not affect the property over which the banker has a lien. In Bombay Dying and Manufacturing Company,[7] the court held that when a creditor has a lien for obtaining satisfaction of the debt, this right is not affected by limitation even though an action thereon is barred by limitation.

- **Pledge:**

Section 172 of the Indian Contract, 1872, defines a pledge or a Pawn, as "the bailment of goods as security for the payment of a debt or performance of promise". The bailor is known as the "Pawner" or "Pledger" and the bailee as the "Pawnee" or "Pledge".

In Lallan Prasad's case,[8] the court held that there are two ingredients of a bond or a pledge namely: (i) that it is essential to contract of Pawn that the property pledge should be actually or constructively delivered to the Pawnee, and (ii) a Pawnee has only a special property in the pledge but

[6] Krishnan Kishore v. United Commercial Bank, AIR 1982 Ca. 62
[7] 1968, SCJ 620. Quoted in Gupta, p. 452.
[8] Lallan Prashad v. Rehmat Ali, AIR 1967 SC 1322.

the general property therein remains in the Pawner and wholly reverts to him on discharge of the debt.

Section 148 of the Act defines bailment as "the delivery of goods from one person to another for some purpose upon the contract that the goods be returned when the purpose is accomplished or otherwise disposed of according to the instructions of the bailer". Thus, delivery of goods and return of goods are two essential requisites of a bailment. In Shatzabi Begum Saheba and others,[9] the Andhra Pradesh High Court had stated the three essential features of a "Pledge' are : (i) there must be a bailment of goods, i.e., delivery of goods, (ii) the bailment must be by way of security, and (iii) the security must be for payment of a debt or a performance of a promise.

Delivery of goods may be physical delivery or constructive delivery. The bailer putting his own lock on the door of the go down storing the goods pledged or even handing over the key of the lock will amount to transfer of the possession of the goods. Similarly, handing over the documents of the title to goods like bill of lading or railway receipt, duly endorsed, will also mean delivery of the goods. In short, pledge is the delivery of goods or documents of title to goods, to the creditor by the debtor as security for a debt, or for any other obligation.[10]

Section 176 of the Act further provides, that if the Pawner makes a default in payment of the debt or performance of the promise at the stipulated time, in respect of which the goods were pledged, the Pawnee may bring a suit against the Pawner upon the debtor promise, and retain the goods pledged as collateral security or he may sell the goods pledged on giving the Pawner reasonable notice of sale. The section further lies down that if the proceeds of sale are less than the amount due in respect of the debt or promise, the Pawner is still liable to pay the balance. If the proceeds of sale are grater than the amount so due, the Pawnee shall pay over the surplus to the Pawner.

Upon a default being made by the Pawner in the payment of the debt or performance of the promise, the pledge gets two distinct rights under Se 176 of the Act. Firstly, the pledge may sue upon the debt and retain the goods as a collateral security.[11] Secondly, he may sell the goods after reasonable notice of the intended sale to the Pawner.[12]

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[9] AIR 1976 AP 273.
[10] See Avtar Singh, Law of Contract, (1999), p. 506.
[11] Kamla Prasad jadawal, v. Punjab National Bank, AIR, 1992, Madhya Pradesh 45.
[12] Mahalinga v. Ganapathi, (1902), 27 Mad 528; Nim Chand v. Jogabandhu, (1894), 22 Cal.

To constitute a contract of a bailment it is essential that the bile should return the same goods to the bailer or dispose them of according to his instructions after the purpose for which the goods were delivered is fulfilled. The deposits of money in a bank account is not bailment because: (i) 'money' is not 'goods', and (ii) the banker is under no obligation to return the same currency notes and coins which are handed over to him at the time of making a deposit.

Letter of Pledge

From a law point of view, there is not necessity for any written evidence of a pledge. In practice, however, a banker usually obtains his customer's signature to a document, sometimes called a letter of pledge. Some banks require their customers to sign a document of this nature in respect of each transaction, in which case the documents of title to the goods are listed in a schedule thereto; other banks obtain the customer's signature to a document which covers all transactions. The clauses contained in both types of document are, of course, very similar. A document of the second type-sometimes called a general letter of pledge-commonly includes the following provisions:

(a) The customer agrees that the bank is to have a pledge upon all gods delivered by the customer or by his agents into the possession of the bank or of its agents and upon all bills of lading and other documents of title deposited by the customer or by his agents, with the bank or with its agents.

(b) The customer agrees that the goods and document of title are pledged as a continuing security for the payment of all sums owed by the customer, either solely or jointly with any other person or persons whether on balance of account or on guarantees or in respect of bills of exchange, and including interest with half-yearly rests and other banking charges.

(c) The customer agrees that in case of default in repayment of such sum or sums on demand, the bank may sell the goods or any part thereof.

(d) The customer agrees to keep the good fully insured in such office as the bank may approve.

(e) The customer undertakes to pay all rent and other expenses of and incidental to the warehousing of the goods.

(f) The customer agrees that the bank is not to be responsible for the default of any broker employed to sell the goods.

➢ Hypothecation:

In case of hypothecation, a mere charge is given on the goods for the amount of the debt but the hypothecated goods remain in the actual physical possession of the borrower, and neither possession nor ownership passes to the bank, or other lenders. The instrument which creates such a charge is known as a letter of hypothecation which states that the goods are at the order and disposition of the ledger until the debt is cleared. As the hypothecated goods remain with the borrower and there is often considerable scope for fraud, this facility is granted to parties of unquestionable integrity and honesty. Hypothecation is, by nature, a weak security. In hypothecation goods remain in the possession of the borrower, who binds himself, under an agreement, to give the possession of the goods to the banker, wherever the latter requires him to do so. The charge of hypothecation is thus converted into that of a pledge and the banker or the hypothecate enjoys the powers and rights of a pledge. In M/secured Gopal Singh, Hira Singh's case,[13] the court observed that in case of hypothecation, "the borrower is in actual physical possession but the constructive possession is still of the bank because, according to the deed of hypothecation, the borrower holds the actual physical possession not in his own rights as the owner of the goods but as the agent of the bank". The High Court, therefore, concluded that in law there was no difference between pledge and hypothecation with regard to the legal possession of the banks-the hypothecated goods are also not only constructively but actually in the possession of the bank. But to enforce its claim it is essential for the bank to take possession of the hypothecated goods are also not only is essential for the bank to take possession of the hypothecated property on its own or through the court. The bank can enforce the security by filing a suit to this effect. If the banker fails to do so, and chooses to seek a simple money decree, the bank would be deemed to have waived its right as hypothecate.[14]

Precautions to be taken by Banker

The position of the banker under hypothecation is not as safe as under a pledge. If the borrower fails to give possession of the goods of hypothecated, or sells the entire tock or borrows from another banker on the security of the same goods, the banker shall have to resort to legal proceedings in a court of law for the recovery of the amount lent. The

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[13] Gopal Singh Hira Singh v. Punjab National Bank and Another, AIR 1976 Delhi 115.

[14] Syndicate Bank v. Official Liquidator, Prashant Engineering Company Pvt. Ltd (1986), 59 Comp. Cases 301, Bank of Baroda v. Babari Bachubhai Hirabhai & Others, AIR 1987 Gujarat , PNB v. Lakshmi Card Clothing and Manufacturing Ltd and Another, 1978 TNL at 89.

advances on hypothecation basis are as risky as clean advances. The banker should, therefore, take the following precautions to safeguard his own position:

1. The facility of loans on the basis of hypothecation of goods should be sanctioned only to persons or business houses of high reputation and sound financial standing.

2. The banker should periodically inspect the hypothecated goods and the account books of the borrower should be checked to ascertain the position of stocks under hypothecation. Care should be taken to see that the unsaleable stocks are not being maintained by the borrower.

3. The borrower should be asked to submit a statement of stocks periodically giving correct position about the stocks and its valuation and declaration that the borrowers possess clear title to the same.

4. Stocks should be fully insured against fire and other risks.

5. A nameplate of the bank, mentioning that the stocks are hypothecated to it, must be displayed at a prominent place in the business premises of the borrower for public notice. This is essential to avoid the risk of a second charge being created on the same stocks.

6. In case the borrowing concern is a joint stock company, the charge of hypothecation must be registered with the Registrar of Companies under Section 125 of the Companies Act, 1956 within a period of 30 days from its creation.[15]

➢ Mortgage:

When a customer offers immovable property like land and building as security for a loan, charge thereon is created by means of mortgage. A mortgage is the conveyance of a legal or equitable interest in real or personal property as security for the debt. Real property is freehold land. Everything else (including leasehold land) is personal property. Deeds are mortgaged (real property) and so are share certificate (personal property). The subject of mortgages of immovable property is dealt within the Transfer of Property Act, 1882. Section 58 of the Transfer of Property Act defines a mortgage as "the transfer of interest in specific immovable property for the purpose of securing the payment of money

[15] P.N. Varshney, banking Law and Practice, (1977), p.4.50.

advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability". The person transferring the interest is called the mortgagor; the person to whom the interest is so transferred is called the mortgagee; the principal money and interest thereon, the payment of which is secured, are called the mortgage money and the instrument, if any, by which the transfer is effect is called a mortgage deed. The transaction itself is called a mortgage or a mortgage transaction. The main characteristics of a mortgage transaction are:

1. The mortgagor does not transfer the ownership of the property to the mortgagee. He transfers only some of his rights as an owner, e.g., he cannot now sell the property without the consent of the mortgagee.

2. Mortgage relates only to immovable properties. Properties mortgaged should be specified by the mortgagee in the mortgage deed. Such. Specification can be done by mentioning the name, location or size of the properties.

3. The object of mortgaging the property is to give security for the loan to be taken or already taken for performance of an engagement giving rise to the pecuniary liability. Transfer of property for any other purpose, e.g., in satisfaction of a loan, will not amount to mortgage.

4. The mortgagee need not be always given the actual possession of the property.

5. The mortgagor gets back all his rights regarding the mortgaged property on repayment of loan, with interest due thereon.

In case of co-owners of a property, each co-owner has a right to mortgage his share in the property.[16]

Types of Mortgages

Mortgages are governed by the provisions of the Transfer of Property Act. The various types of mortgages recognized and governed by this Act under Section 58 (b) to 58 (g) are as follows:

Simple Mortgage

[16] Debi singh v. Bhim singh & Others, (1971), AIR Delhi, 316.

According to Section 58 (b), a simple mortgage is one where " without delivering possession of the mortgaged property, the mortgagor binds himself personally to pay the mortgage money and agrees expressly or impliedly that in the event of his failure to pay according to his contract, the mortgagee shall have a right to cause the mortgaged property to be sold and the proceeds of the sale to be applied so far may be necessary, in the payment of the mortgage money".

Thus, in simple mortgage, the mortgagee has two fold security for the debt-

(i) the personal obligation of the mortgagor; and
(ii) the property.

The mortgagee has no right to sell the property directly; the sale must be through the intervention of the court. The mortgagee will have to obtain first a decree from the court for sale of the mortgaged property since the words used are "cause the mortgaged property to be sold".

In case of such a mortgage if the mortgagor sells the property, the purchaser takes the property subject to the mortgage but does not incur any other personal obligation, as was the case with mortgagor.

Mortgage by conditional Sale

According to Section 58 (c) of the Act, mortgage by conditional sale is one where mortgagor ostensibly sells the mortgaged property on the condition that-

(i) on default of payment of the mortgagee money on a certain date, the sale shall become absolute, or
(ii) on such payment being made, the sale shall become void, or
(iii) on such payment being made, the buyer shall transfer the property to the seller.

The essential characteristics of such a transaction are:

(i) It is an ostensible sale and not a real sale
(ii) The ostensible sale is subject to a condition-
    (a) the ostensible sale ripens into real sale in case the mortgagor defaults in payment, or
    (b) incase the mortgagor makes payment, the mortgagee has to retransfer the property to the mortgagor.
(iii) The possession of the property continues with the mortgagor.
(iv) The fact that transaction is a mortgage should be specified in the document of sale.

(v) The mortgagor does not have any personal liability; therefore, in case the mortgaged property is not sufficient to pay off the mortgagee's claim, he cannot recover the balance out of any other property of the mortgagor.

Usufructuary Mortgage

In case of usufructuary mortgage the mortgagor gives possession of the property or binds himself, either expressly or by implication, to give such possession to the mortgagee. The mortgagee is authorized to retain his possession over the property until the payment of the mortgage money is made and to receive rents and profits accruing from the property and to appropriate the same in lieu of interest or in payment of the mortgage money or in both.

The chief characteristic of usufructuary mortgage is the transfer of the possession over the mortgaged property to the mortgagee, who is entitled to receive income accruing these from and to appropriate the same towards the payment of the mortgage money and/or interest thereon. The liability of the mortgagor is thus gradually reduced.

As the mortgagor does not bind himself personally to repay the mortgage money, no suit for the repayment of the mortgage money can be filed against him. The mortgagee is also not entitled to file a suit for sale or foreclosure of the mortgaged property. He has only one remedy, i.e., to retain his possession over the property and to recover his dues from the income accruing therefore. The mortgagee is thus placed in a disadvantageous position, as he shall have to wait for a long period to recover his dues.

English Mortgage

In cash of English mortgage, the mortgagor binds himself to repay the mortgage money on a certain date and transfer the mortgaged property absolutely to the mortgagee on the condition that the mortgagee will re-transfer the same to the mortgagor upon payment of the mortgage money. The mortgagee under an English mortgage is entitled to immediately possession and to retain possession until he is repaid. Thus, the mortgagor-

(i) incurs personal liability to pay, and
(ii) in addition transfers the mortgaged property absolutely, i.e., with all the interests and rights in the property.

In case of default by the mortgagor, the mortgagee is entitled to sell the property without seeking permission of the court in special circumstances mentioned in Section 69.

Mortgage by Deposits of Title Deeds or Equitable Mortgage

According to Section 58 (f) of the Act, where a person delivers to a creditor or his agent documents of title to immovable property, with the intention to create a security thereon, the transaction, is called a "mortgage by deposit of title deeds". However, the Act makes the provisions of this Section applicable only to towns of Bombay, Calcutta and Madras and such other towns as may be specified by the State Government by notification in the official Gazette in this behalf. This mortgage does not require registration. It is most popular with banks.

Anomalous Mortgage

A mortgage other than any of the mortgages explained above is an anomalous mortgage. Such a mortgage includes a mortgage formed by combination of two or more types of mortgages. It may, therefore, take various forms depending upon custom, local usage or contract.

Legal Mortgage and Equitable Mortgage

On the basis of transfer of title in the mortgaged property, mortgages can be classified into the following two categories:

(i) Legal Mortgage
(ii) Equitable Mortgage

In a legal mortgage, the mortgagor transfers to the mortgagee the legal title to the property. It must be registered in the case the amount of loan is Rs.100 or more. On repayment of the loan the mortgagee transfers the title to the mortgagor. In case of an equitable mortgage, the mortgagor deposits the title deeds with the mortgagee with the intention of giving the mortgagee an equitable interest in the property. It does not require registration.

Procedure for a Legal Mortgage

(i) If the principal money secured is Rs.100 or more, the instruments must be registered.
(ii) The mortgage is complete as soon as the deed is registered but it will be effective from the date of execution. The deed is to be signed by the mortgagor and two witnesses.

Procedure for Equitable Mortgage

(i) The mortgagor should deposit the title deeds relating to his property with the bank wherefrom his is taking the advance. In case the advance is made by a bank, which is not situated at a notified place, the title deeds may be deposited with another branch of the bank, which is at a notified place.

(ii) The mortgagor is required to send a covering letter with the title deeds acknowledging the deposit of title deeds with the intention to create an equitable mortgage thereon to secure a specific debt or debts.

(iii) The bank should only accept the documents in original.

(iv) The bank should also maintain an equitable mortgage register wherein details such as date, time, or the deposit, particulars of advance and a list of documents should be entered in that register.

(v) Tax receipts should also be verified.

(vi) In case the mortgagor is a limited company, the mortgage must be registered within 30 days of execution of the mortgage.

Advantages of an Equitable Mortgage

(i) It is economical and does not require registration. Hence, the stamp duty can be saving.
(ii) Secrecy can be maintained because no witnesses are required.
(iii) Charge can be created simply by deposit of title deeds with the mortgagee.
(iv) It provided the mortgagee the same remedies as are available in legal mortgage.

Disadvantages of an Equitable Mortgage

(i) Property mortgaged can be realized, when required, only through the court's orders. The process is expensive and time consuming.
(ii) The mortgagee has to be extra cautious. In no case he should part with the title deeds.

Remedies of a Mortgage

In the event of default by the mortgagor, a legal mortgage has the following remedies available with him:

(i) Sell the property/land (this includes, of course, any property and building on the land);
(ii) Appoint to receiver to collect any rents arising out of land;
(iii) Enter into possession of the land; and
(iv) Apply to the court to have the legal estate (the ownership) transferred to the mortgagee. This is known as application for 'foreclosure' and is rarely granted. The court usually orders a sale.

In addition to these four rights of action, a mortgagee has the right to sue for repayment of the debt.

An equitable mortgagee has similar rights but these must be pursued through the courts. The remedies are:

(i) Apply to the court for an order for sale:
(ii) Apply to the court for an order for foreclosure;
(iii) Apply to the court to appoint a receiver for rents; and
(iv) Apply to the court for an order to compel the debtor to execute a legal mortgage. The remedies of a legal mortgage then become available.

Again, an equitable mortgagee also has the right to sue for repayment of his debt.

- **Floating charge:**

It is the charge created upon the movable assets of a running business. The charge will not be crystallized at the time of its creation. But it will be crystallized only at the happening of certain events like recall of advance or closure of business by the firm. During the subsistence of the floating charge, the business concern may make use of the assets charged freely for its business purpose as if no charge is created upon it. When the business ceases to exist the charge will take effect. The crucial question here is whether there will be any movable assets at the time of closure of business. However, as an instrument of securing the interest of the creditor floating charge plays a very dominant role. It is also useful as a charge upon the assets acquired in future by the business concern.

- **Negotiating the securities:**

Negotiating the Securities is comparatively a new concept of asset recovery. This is based on a principle that ` one at hand is better than

two in the bush'. Negotiating means passing the interest in the security for valuable consideration. The enforceable interest in the security is assigned in favour of another person or institution, who in turn would enforce the security against the Debtor. Usually it is done at a discounted rate.

Recently negotiating the securities has become a major area of business. Asset Reconstruction Companies have been set up to purchase and sell the assets and securities. The securitization act also provide for the establishment of Asset Reconstruction Companies. The banks like Standard Chartered Bank, Kotak Mahindra Bank, I.C.I.C.I Bank etc. have become major players in the market. Many other banks have established their own subsidiaries to deal with negotiating and taking over the securities.

- **Legal effect of Documentation:**

The security of a credit facility depends largely on the correctness of documentation. Whenever a creditor wants to establish his legal right to recover the loan he has to depend on the documents which evidence the transaction. A faulty documentation may upset the prospect of recovery. The details of loan transaction like the amount of loan, rate of Interest repayment period, terms of payment etc. are clearly described in the document.

With the establishment of Tribunals to recover the debt where the oral evidence is not given much weight age, the disputes are adjudicated on the basis of documents only. In such a situation a proper claim can not be put forward unless the documents are properly executed.

With the enactment of SARFEASI Act 2002, the banks and Financial Institutions can enforce their right against secured assets without the intervention of the Court. For this purpose the security right must be properly documented. In nutshell, the success of Recovery depends largely on documentation.

- **Realisation of securities:**

From the above discussion it becomes clearly that documentation has a vital role to play with respect to realization of securities. What is the appropriate time to realize security is a question of prudence. A wise decision has to be taken by a creditor with respect to the timing of realization of securities. Any delay in enforcing the security in time will result in deterioration of security and there by the security note fetching the requisite value. This will hamper the process of recovery. For ex: in case of loans secured by stocks, the security has to be off loaded when

the share market is at its peak. A wise credit decision is the essence of realization of securities.

> **Documentation:**

Documentation is the process of reducing the terms and conditions of loan into appropriate writing. It is the evidence of transation between a creditor and Debtor. As far as there is no dispute on the factor of Debtor creditor relation Documentation has no role to play. At the event of any dispute, Documentation will come to provide supporting evidence of the transaction. Documenting a loan transation was a practice followed from the olden days. The Gold Smiths, local money lenders, Indigenous Bankers etc. used to keep a record of their accounts and lending inscribed on palm leaves, on leather and some times on cloth also. This would perhaps be the initial form of Documentation. With the growth of time it has developed into hundies. As a security to the amount advance as loan the money lenders started taking some written notes which have been developed into promissory note in course of time. With the development of trade and intercourse promissory notes gained vide acceptability as a loan document.

In order to bring in more certainty it has become necessary to reduce into writing the term and conditions governing the transactions. When the terms and conditions are agreed between the parties a become a loan agreement. It is a commercial practice to secure the amount of loan by additional securities like guarantee of third parties, a collateral security of movable and immovable properties, stock in trade, receivables etc. All these securities require written documents. Now a day all the banks and the Financial Institutions have developed a well established system of standard documentation.

CHAPTER – IV

NON PERFORMING ASSETS & CLASSIFICATION

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Banking Sector Reforms have been in progress as part of economic reforms initiated in 1991. The need to have a healthy, vibrant, stable and viable banking system to give life support to the economic growth of the country, has been engaging the attention of the authorities for quite some time. This has become all the more essential as the globalization process is in the progress and the banks have a key role to play as facilitator of smooth and efficient integration of global financial markets. The Committees which have gone into the working of the financial system and the banking sector have come out with certain significant measures to strengthen the banking system. One of the major recommendations of the Committee on Financial System related to Income Recognition and Asset Classification by banks, which brought to surface the menace of Non Performing Advances and exposed the dimension and seriousness of its proportions. The philosophy underlying Banking Sector Reforms has been to achieve efficiency, productivity and profitability in the banking system through sound banking practices, which, inter alia, include implementation of Prudential Norms on Income Recognition and Asset Classification.

The Prudential Norms require banks to pay adequate attention to the quality of assets. In fact, the general feeling is that, had these norms been observed in spirit earlier, much of the problem of NPAs confronting the banks today could have been avoided. In retrospect it would appear that the seeds of NPAs were sown precisely during the cycle of uninhibited credit expansion (including non-cautious target oriented lending under priority sectors) and banks are reaping the whirlwind of cumulative problems being faced by them now, a few years down the line after a lending binge.

If the Balance Sheet of a bank is among other things expected to reflect the actual financial health of that bank, there has to be a fool proof system of recognition of income, classification of assets, and provisioning for bad debts on a prudential basis. The Committee on Financial System had recommended that the policy of Income Recognition should be objective and classification of assets should be based on record or recovery rather than any other subjective considerations, and that provisioning should be made on the basis of classification of assets into different categories of their status. In April 1992, it was decided by the Government and Reserve Bank of India to implement the Narasimham Committee's recommendations, with certain modifications, in a phased

manner over a three year period commencing from Accounting Year 1992-93. As per the extant Prudential Guidelines governing Income Recognition and Asset Classification and Provisioning issued by Reserve Bank of India, banks have to classify any amount due but not paid for two quarters (irrespective of whether the dues related to term loan, cash credit, overdraft, bills payable/discounted etc.) as NPA and should not recognize any Income Receivable in respect of such asset. Against erstwhile eight health code based classification followed by the banks, Advances are required to be classified into four broad groups: (1) Standard Assets (2) Sub-standard Assets (3) Doubtful Assets and (4) Loss Assets. Broadly, the classification of assets into these categories has to be done taking into account the degree of well-defined credit weaknesses and the extent of dependence on collateral security for realization of assets. Extent of Provision to be made would be dependent upon the NPA category and security cover available therefore.

- **<u>Factor responsible for its drawbacks:</u>**

An asset, including leased assets, becomes Non-Performing when it ceases to generate income for the bank. [17] A Non-Performing Asset (NPA) was defined by Reserve Bank of India, as a credit facility in respect of which the interest and /or installment of principal has remained 'past due' for a specified period of time. The specified period was subsequently reduced by Reserve Bank of India in a phased manner as under:

Year ending March 31	Specified periods
1993	Four quarters
1994	Three quarters
1995 onwards	Two quarters

An amount due under any credit facility is treated as 'past due' when it has not been paid within 30 days from the de date. Due to the improvements in Payments and Settlements System, recovery climate, up-gradation of technology in the banking system, etc. It was decided to dispense with 'past due' concept, with effect from March 31, 2001. Accordingly, as from that date, Non-Performing Asset (NPA) shall be an advance where:

(i) Interest and/or installment of principal remain overdue for a period of more than 180 days in respect of term loan.

[17] Reserve Bank of India, Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provision., August 2001.

(ii) The account remains 'out of order' for a period of more than 180 days, in respect of an Overdraft/Cash Credit (OD/CC).

(iii) The bill remains overdue for a period of more than180 days in the case of bills purchased and discounted.

(iv) Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two and half years in the case of an advance granted for agricultural purposes.

(v) Any amount to be received remains overdue for a period of more than 180 days in respect of other accounts.

With a view to moving towards International Best Practices and to ensure greater transparency, it has been decided to prospectively adopt the '90 days overdue' norm for identification of NPAs, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a Non-Performing Assets (NPA) shall be a loan or advance where:

(i) Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of term loan.

(ii) The account remains 'out of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit (OD/CC).

(iii) The bill remains overdue for a period of more than90 days in the case of bills purchased and discounted.

(iv) Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two and half years in the case of an advance granted for agricultural purposes.

(v) Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

Out of Order Status: An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the Principal Operating Account is less than the sanctioned limit/drawing power, but there are no credits continuously for six months as on the date of balance sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Overdue: Any amount due to the bank under any credit facility is overdue' if it is not paid on the due date fixed by the bank.

It is necessary to take note that even these delayed stringent measures are welcome despite the fact that these measures would initially put the banks in a tight-jacket so far as NPAs are concerned.

Causes:

The factors leading to NPAs can be broadly categorized under political, economic, social and technological reasons.

Political interference in the lending process of banking leading to the neglect of proper credit appraisal, need-based credit, follow up and supervision has been projected as one of the major reasons for increasing Non-Performing Advances. Political connections are widely perceived but, as is the case with willful defaulters, difficult to prove. Almost certainly the public sector character of banks and their vulnerability to outside influence has been a dampener even in loan recovery. Directed lending, loan meals, credit to various segments under political influence have caused neglect of appraisal, scrutiny and basic principles of lending, resulting in lethargy in repayments or non-repayments and difficulty in recoveries of loans since there is always an air of expectancy that small loans and agricultural loans in particular may be waived or totally written off en-masse under political patronage.

Economic causes can be external or internal. Several studies have gone into the causes of Non-Performing Advances and come to the conclusion that changes in the macro-economic environment like recession, infrastructural bottlenecks, change in Government policies, etc. result in some lending of banks becoming unproductive and borrowers turning defaulters. Changes in Economic policy, i.e., Fiscal and Monetary, effected in response to the economic and political needs from time to time in the context of domestic and international scenario, have a bearing on the performance of banks and business, as also on loans going bad. Changes in Industrial and Agricultural policies, Export Import Policy, Credit Policy, Exchange Rate policy, Labour policy are also stated to have partially contributed to the failure of some borrowers in the repayment of loans, as the borrowed funds could not be used fruitfully due to some of the unfavorable impact and effects of policy measures. Both banks and borrowers have been caught unaware by the fact changing policies and find themselves trapped with funds locked up in units producing nothing. [18] While banks and borrowers have not much of control over

[18] K. Kannan, former Chairman and Managing Director, Bank of Baroda, *The Discussion*, the author had with him on July 3, 2002

external factors, lack of co-ordination between banks and other agencies involved particularly to have a tie-up for funding requirements, etc. adds to the woes of the borrowers making them difficult to perform. Factors like diversion of funds for business expansion/diversification of associate concerns, business/market failure, time/cost overrun in the implementation of projects, inefficient management on the part of borrowers etc. have resulted in poor utilization of credit and consequent repayment problems. Willful default by some of the borrowers taking advances of weak legal system is cited as another major cause of NPAs. On banks' side, delay in the sanctioning of loans, grant of inadequate credit, deficiency in the credit appraisal standards, lack of supervision and follow-up, general level of inefficiency in containing the cost of funds due to very high overheads, poor productivity, high intermediation costs, low level of technology and high rate of interest charged to borrowers to cover up the loss on account of Non-Performing Advances, have been emphasized as important causes for mounting NPAs.[19]

On the social side, lack of education and enlightenment among the borrowers buttressed with poor legal infrastructure generally stated to be supportive of the borrowers rather than lenders and corruption have been observed to be major stumbling blocks in the recovery of loans. Lack of integrity on the part of both bankers and borrowers has also influenced formation of NPAs. Erosion in social values, ethics and accountability has been highlighted as some of the reasons for formation of huge NPAs. Awareness that banks lend public money which is required to be returned, is unfortunately found missing, aggravating the problem of recovery of loans.

The other causes aggravating the problem of NPAs can be found in the inability of borrowers to tie-up the required funds as promoters' contribution, and in general financial indiscipline in the utilization of funds for the purpose for which loans are availed, inordinate delay in realization of their own dues from debtors, poor capital market support, lack of competitive spirit in the conduct of business and ability to cope with the competition observed in product market, capital market, money market and foreign exchange market witnessed under the liberalized environment. Change from closed economy to open economy has exposed the weaknesses in the area of efficiency, quality, cost etc., resulting in the inability to compete in the open market which in turn has resulted in the units turning sick /getting closed without having funds to clear the banks' dues. Lack of accountability on the part of

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[19] Some Aspects Relating to NPAs in Commercial Banks, *Reserve Bank of India Bulletin*, July 1999, p.913 and A.T. Paneer Selvam, *The Report on Non Performing Assets of Public Sector Banks*, 1998.

borrowers, lenders, auditors, accountants, lawyers, values and all connected professionals have also been accelerating NPA formation.

Non Performing Advances were the result of lending directed by government, on contact considerations, and a debtor-friendly definition of Non Performing Advances. When NPAs were redefined, many 'good' loans suddenly became bade of Non-Performing. There was no bringing of defaulters, to book, because they had ways to hold up action. The fetish for secrecy resulted in information regarding defaulters not being shared between lenders, and to their name not being published. Borrowers influenced this penchant for secrecy. The inexplicable delays in setting up adequate Debt Recovery Tribunals also points to the malign influence of corporate borrowers. Chambers of Commerce which is vocal about the need for lowers interest rates or for Indian lenders to be more sympathetic to borrowers has never taken action against many of their defaulting members. Some of them are even honored with important positions.[20]

Lack of technological advancement which can help in reducing the cost of funds, faster movements of funds, ensuring efficient and effective payment and settlement system is also stated to be one of the reasons for growing NPAs.

The major culprits behind high NPAs levels are willful default, mismanagement and lack of planning. Public money obtained from banks has been systematically siphoned away from our industries.[21] The problem of NPAs has degenerated to such as extent where in an effort to assign the blame, even Trade Unions have ventured in recent times to publish lists of defaulters because of whom, they consider that some of the banks are in dire financial straits. These lists are over and above the official lists published by Reserve Bank of India of bank-wise defaulters of Rs One crore and above in the banking system.

With the introduction of varieties of debt instruments like commercial paper, corporate bonds, debentures, etc. in the credit market and linking of interest rates to the market forces and credit worthiness of the borrowers, many of the better rated corporate concerns have moved away

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[20] SecuredL. Rao, Regulation of Financial Services, The Economic Times, May 27, 2002.
[21] K.V. Krishnamurthy, At No Rate, *The Business Standard*, June 13, 2002.

from banks, leaving the latter with only second and third rung borrowers. This adds to the problem of NPAs of banks. [22]

The history of NPAs is complex. Poor appraisal quality and lack of appreciation and understanding of broader economic, financial, and market forces impacting project and corporate viability are major reasons. External pressures in credit decisions have played their part. Lack of integrity on the party of some appraising officials and bank managements is another proximate cause. One more significant factor is the log-jam in accessing collateral and recovering its market value because of legal hurdles.[23]

The Reserve Bank of India Bulletin argues that India's high level of NPAs is a historical legacy. This is a rather dubious claim. It is far better to focus on the systemic failures such as lacunae in the credit recovery system, arising from inadequate legal provisions on foreclosure and bankruptcy, long drawn-out legal procedures, and difficulties in the execution of the decrees awarded by the court. These continue to be a feature of the present financial situation. Banks may themselves play an important role in raising NPAs levels through sheer delay in offering adequate credit limits to working capital and thus lead to poor operating results.[24]

Other causative factors responsible for NPAs relate to cyclical weaknesses, structural weaknesses and miscellaneous reasons.[25]

The weak capital position of Indian banking system is largely a reflection of growing asset-quality problems stemming from weak underwriting and credit management systems and vulnerabilities of the Indian banking sector to the impact of globalization on the country's key industrial sectors. The asset-quality position has also suffered from regulations with respect to lending to priority sectors.[26]

Banks are derivative institutions. The health of the real sector is reflected in the banking system's health. If the credit discipline is weak

[22] Muthili Bhusnurmath, Setting the Record Straight-Finance Street, *The Economic Times*, April 20, 2002.
[23] NPA Information from *The Economic Times*, 'SCBs need $13 bn to support Asset Losses' December 20, 2000.
[24] S. Venkitaramanan, There is More to NPAs than Poor Credit Appraisal, *The Business Line*, July 12, 1999.
[25] Reserve Bank of India, *Study on Geographical and Sectoral Distribution of NPAs in Banks*, April 2001.
[26] SCBs need $ 13 bn to support Asset Losses, *The Economic Times*, December 20, 2000.

and state intervention in the financial sector is pronounced, there is every possibility that the banking system will be weak and often unsound.[27]

Experience from and around the world indicates that poor credit quality coupled with weak credit risk management practices continues to be a dominant factor in bank failures and banking crises. Sever credit losses in a banking system reflect simultaneous problems in several areas such as credit concentrations; credit processes issues and market and liquidity sensitive credit exposures.[28]

Effects:

The problem of NPAs Indian Banking System is somewhat similar to malignancy in some part of the body. The ripple effect of NPAs as in the case of cancer, is gradually felt in all parts of the economy viz., savings, investments, production, employment and services affecting adversely the capital formation, economic growth, fiscal deficit, inflation and finally the country's rating and confidence level so far as the international image and standing are concerned. The efficacy of the banking system to act as an efficient intermediary is dependent on its soundness based inter alia on its quality of assets particularly advances.

The high level of NPAs in banks and financial institutions has been a matter of grave concern to the public especially as bank credit is a catalyst for economic growth of the country. Any bottleneck in the smooth flow of credit, for which one cause is the mounting NPAs, is bound to create adverse repercussions in the economy. NPAs are not therefore the concern of only lenders.

NPAs constitute a real economic cost to the nation in that they reflect the application of scarce capital and credit funds to unproductive uses. The funds locked up in NPAs are not available for productive use or recycling and to the extent that banks seek to make provision for NPAs or write them off, it is a charge on their profits. To be able to do so, banks have to charge their productive and diligent customers a higher rate of interest. It thus, becomes a tax on efficiency. It is the customer who uses credit efficiently that subsidizes the inefficiency represented by NPAs. This also raises the transaction cost in the system by denying the

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[27] Rashid Jilani, NPA-Issues and Prospects, *PNB Monthly Review*, August 1999.

[28] Best Practices for Credit Risk Disclosure – Bank for International Settlements, *BASEL*, July 1999.

diligent credit customers benefit of lower rates which would help them to be more efficient and competitive. NPAs in short, are not just a problem for banks; they are bad for the economy.

The NPAs reflected in the books of banks do not show the complete picture because an identical amount has been written off from the books in the past several years. NPAs do not general any revenue and impact the bottom-line because the had earned money from performing assets has to be diverted to meet the provisioning needs of NPAs. NPAs over Rs 33,000 crore are still to be provided for by the nationalized banks. At the current rate of earnings, it will take another 15 years to write off the existing NPAs.

The NPAs arrived at Rs 54,733 crore on a conservative basis by Public Sector Banks, pose a serious threat to the very survival of the banking system and unless this malady is checked/controlled on a war footing, the very growth of the real sector and integration of the economy will be a distant dream and will only amount to chasing a mirage. The need to have a sound and stable banking system is sine qua non, for the development of the economy and as such there is a paramount need to strengthen the balance sheet of the banking system which directly depends on the quality of its assets, particularly advances.

Not only high NPAs affect the profitability of the banks, but they also put stress on the financial system as a whole, as more capital has to be brought in. Besides, as NPAs increase, banks tend to shy away from further lending. It is pertinent to note that the net profits posted by the 19 state run banks in 2000-01 were largely due to the entry of recapitalisation bond interest income. This saved these banks the blushes. In 2000-01 the cumulative net profit of theses banks stood at Rs 2,095 crore. After adjustment for the recapitalisation bond interest income, the figure stands at a measly Rs 299.61 crore. This is less than the cumulative net profit that a handful of foreign banks with a shade over 100branche and less than Rs 50,000 crore in assets, posted in 2000-01 nearly Rs 1,000 crore. The irony here is that on the asset side, it is Government Securities that is acting as a buffer. Net bad loans for the system stands at around Rs 33,000 crore. With little by way of quality assts coming up and standard assets also going awry due to the recession, Government of India's secured investment is good news for banks. In other words, it is the fiscal deficit inducing the center's appetite for funds which is bailing out banks. As a banker put it "Had there been a balanced fiscal planning, there would have been no need to issue this quantity of bonds. Where would that have left us?"

First, there could be no automatic lowering of lending rates unless NPAs of banks are brought down substantially. Given the level of NPAs, banks build the cost of NPAs into their lending rates. Second, banks will have to reduce their expansion if deposit and lending rates are to be aligned.

Thus, any financial system that works on a net profit of 0.33 per cent and a gross NPAs level of over 12 per cent cannot sustain itself for long.

The implementation of the norms for Asset Classification and Income Recognition introduces transparency in the Profit and Loss Accounts and Balance Sheets of commercial banks. Such a transparency has three distinct effects.

(i) To begin with, there is the liquidity effect. Where a bank does not really receive interest and is merely capitalizing it in borrowers account, there is loss of flexibility. In particular, the bank loses the opportunity to redeploy the income stream for a better purpose.

(ii) There is an effect on bank profitability. Unrealized interest receipts, when booked as income cannot just be missed as harmless window dressing. It has important implications. Besides, the loss of creditability of the financial statements, doctored declarations of profits can accelerate the erosion of a bank's capital base through unjustified tax and dividend payments.

(iii) There is an effect on the Balance Sheet of the bank since Non-Performing Advances need to be provided for and eventually written off against Capital and Reserves. If adequate Provision is not made against Non Performing Advances, it will impair the banks' capital base thus, reducing the protection available to depositors and creditors of the bank.

Banks have to make provisions on advances depending on the classification of assets ranging from 10 to 100 per cent. Quite clearly there is a link between Capital Adequacy will have to be met after ensuring that adequate provisions have been made. Thus, the task before the commercial banks in reaching Capital Adequacy is truly difficult.

Banks have remained risk averse and are especially chary of lending to new clients (Projects) because of high level of NPAs. Decision takers in banks indulge in passing the buck; loan proposal pile up unattended at bank head-quarters. The interference of vigilance machinery also acts as a deterrent in taking decisions by bankers. Bankers live a life of daily confrontation with the risk of failure of their loans for no fault of theirs. They may find faults in the loans they have given and find them turn duds later. If a vigilance enquiry has to be conducted for every such failure, a genuine mistake or misjudgment, global banking would have come to a halt long ago. The vigilance set up in New Delhi, which superimposes its judgment on that of the bank authorities, is foreign to the problems and technology of banking. Quite often, the Vigilance Commission does not take into account the practical problems of credit appraisal and errs too much on the side of caution. To quote a banker "Public Sector Bank officers are constantly in fear of prosecution by the vigilance department anytime in their career. Neither the fact that a decision was justified at the time it was taken, nor the enormous time gap between the dates of decision and the dates of questioning of officer, nor even the undue delay-unconscionable in many cases-in taking action, appears to be a deterrent to the judgment of vigilance machinery. Unless this basic issue is addressed and remedied, it is too much to expect the banks to function as commercial organization. Worse, if the present system of vigilance is not revamped quickly the PSBs could become weak and decrepit organizations in a few years (R. Viswanathan).

Since new borrowers (investors) are discouraged, it is the established clients (both good and bad) who are being pampered by the banks. Regardless of the quality of bus., established clients get the benefit of Reserve Bank's policy of brining down lending interest rates. Indeed, it would seem that this nexus between the banks and established business (which command tremendous clout) is acting as a barrier to new entrepreneurs and new investments.

India's banking system is creaking. If the country does not find the capital to revive its weak Public Sector Banks and to address the mounting problem of Non-Performing Advances, it's banking system will flounder with devastating consequences for the broader economy. To fend off insolvency, Indian banks will need to find fresh capital of $9 billion to $ 15 billion representing 2 to 4 per cent of country's Gross Domestic Product and 50 to 90 per cent of the current capital of Indian banks during the next five years, which is roughly the time it will take to reform the system. Up to 60 per cent of this sum will be required to write off irrecoverable loans, 18 per cent to finance productive improvements and the rest to support growth. Some 35 domestic

banking institutions, accounting for 40 per cent of the sector's assets, are particularly fragile because of the poor quality of their assets. It is from these troubled banks that the vulnerability of India's banking system largely arises.

World Bank studies have indicated that on a minimum Capital Adequacy Ratio of 8 per cent, if the net NPAs of a bank reach 15 per cent, then its capital will get wiped out. Therefore, exceed 15 per cent, the system is like to be in distress and unsound. Out of 27 Public Sector Banks, while one bank has net NPA of 18.3 per cent, four banks have net NPAs exceeding 10 per cent as on 31st March 2001.

The banking system in India, especially the state-owned banks' finances are not in a healthy condition. One sign of illness is the high stock of non-performing loans (NPLs). The NPLs are about 5 per cent of the gross domestic product (GDP). Some analysts claim it could be as high as 6 to 7 per cent of GDP. These banks run the risks of not remaining on going concerns for long. The capital base will be depleted and they will soon need surgery. This coasts a lot of money to the Government. The Centre has already spent over 1 per cent of its GDP in recapitalizing Public Sector Banks in the last decade. This fiscal, the total cost of bail out was estimated at about 3 per cent of GDP.

- **Narsimham Committee Recommendation:**

According to Shri. M. Narasimham, in the matter of providing credit, Public Sector Banks is not functioning like bankers but rather like banking Civil Servants. It is to be noted that nobody has the divine right to borrow and not repay.

The performance of Public Sector Banks leaves much to be desired from the angle of credit expansion, intermediation cost, profit and the level of Non-Performing Advances. All their achievements get suppressed with the predominant presence of Non-Performing Advances particularly after they came to surface with the implementation of Prudential Norms on Income Recognition and Asset Classification. There is a perceptible change in the complexion of banks since 1993 when the Prudential Norms came into force. The banks have developed a tendency to expand investments in preference to making available credit, as revealed by the statistics. This change has an adverse impact on the performance of the economy with cascading effects as flow of credit towards productive

ventures for creation of assets, employment, etc. has not been at the desired level and the major reason is said to be the ever growing level of Non Performing Advances. The funds identified as Non-Performing in banks are also Non-Performing as far as the economy is concerned and hence, the seriousness of the problem. No nation can afford to keep scarce resources idly blocked in the hands of a few borrowers and penalize the tax payer to bail out affected banks. The performance of Public Sector Banks in the areas of Deposits, Advances and Investments comparative position as also their relative Ratios is brought out in the Table 1.

Table 1.

Performance of Public Sector Banks

Year	Deposits	Advances	Investments	Total Assets	Net Profit	Gross NPAs
1993	263315	169340	99889	336181	-3366	39253
	-78.3	-50.4	-29.7			-11.7
1994	303392	165621	132810	378304	-4423	41041
	-80.2	-43.8	-35.1			-10.8
1995	348938	197352	150432	438829	1116	38385
	-79.5	-45	-34.3			-8.7
1996	390820	231321	162667	505845	-371	41661
	-77.3	-45.7	-32.2			-8.2
1997	449329	244214	191058	556296	3095	43577
	-80.8	-43.9	-34.3			-7.8
1998	531723	284971	227102	649504	5030	45653
	-81.9	-43.9	-35			-7
1999	636810	325328	276802	770145	3253	51711
	-82.7	(42.4	-35.9			-6.7
2000	737280	380077	333414	890951	5116	53294
	-82.8	-42.7	-37.4			-6
2001	859376	442134	394107	1029770	4317	54773
	-83.5	-42.9	-38.3			-5.3
2002	93.7361	527.324	424106	22,30.661	5418	62682
	-92.7	-41.1	-40.3			-6.1
2003	103.8472	737162	58.317	31,51,021	6291	68311
	-101.4	-72.3	-56.8			-6.6
2004	114.9561	893,143	69,712	4,631,138	7234	6371

	-112.6	-86.2	-67.1			-6.3
2005	1,278,421	934,784	78,911	49,42,157	8432	6122
	126,3)	(92,3)	(76,1)			-6.1
2006	1,36,4328	14,286	83,276	53,479	9638	5934
	(134,1)	(10,1)	(81,2)			-5.8

Source: Trend and Progress of Banking in India, Issues 1993 to 2006.

Note : Figures in brackets indicate percentage to Total Assets.

Table 2

Performance of Public Sector Banks on Incremental Basis

(Rs in crores)

Particulars	Incremental Deposits	Incremental Advances	Incremental Investments	Incremental NPAs
2006 over 1993	6,98,061.0	4,79,794.0	5,83,218.0	19,520.0
Percentage variation	226.4	161.1	294.5	39.5
Incremental ratio to deposits	---	45.8	49.4	2.6

While the incremental Credit-Deposit Ratio stood at 45.8 per cent as at end March 2001 over the period end March 1993, the incremental Investment-Deposit Ratio during the same period worked out to 49.4 per cent indicating banks' marked preference for safe investment rather than risky lending (Table 2). This is further evidenced by the fact that investments as a percentage of total assets have gone up from 29.7 per cent in March 1993 to 38.3 per cent in March 2001. During this period advances have come down from 50.4 to 42.9 per cent. This clear shift in business mix is to avoid credit risk and consequent losses by way of reduction in interest income, provision towards bad debts, write-off of loans, legal expenses, other maintenance costs of securities against Non-Performing loans, etc. Contribution of profit from the advances has been on the decline.

The loss of opportunity cost to Public Sector Banks on account of NPAs arrived at in a study indicates the following.

Table 3

Loss of Opportunity Cost to PSBs

Year	Total Advances	Gross NPAs	Gross NPA over 5% of total advances	Maintenance Cost @ 11%	Bank Rate	Opportunity Cost at Bank Rate compounded with quarterly rests	Total Loss col. 5 + Col.7
1	2	3	4	5	6	7	8
1998	2,84,971	45,653	31,405	3,455	10.50	3,430	6,885
1999	3,25,328	51,710	35,444	3,899	8.00	2,922	6,821
2000	3,80,077	53,294	34,290	3,772	8.00	2,827	6,599

Source: Indian Banks Association Bulletin, July 2001

Note : The Gross NPAs have been taken into account over and above the 5% level of NPAs assuming that this is the International Standard of NPAs.

Table 3 indicates that NPAs are directly and indirectly hitting the bottom line of PSBs and nullifying their efforts to increase their profitability.

With the increasing trend in Non Performing Advances and declining trend in gross advances the very nature of shift in the profile of banking business and the question of survival of banks is becoming a cause for serious concern. More than the figures, the psychological impact of Non Performing Advances on the whole system does more damage on business morale. To eliminate the matter bail out weak NPA ridden banks using tax resources (which has become the recurring order); the problem of persisting Non Performing Advances needs to be urgently checked and rectified.

Based on the Narasimham Committee recommendations, Reserve Bank of India has implemented the Prudential Norms for improving the financial health of commercial banks and the quality of their loan portfolio. The Prudential Norms on Asset Classification, Income

Recognition and Provisions have come into effect from the accounting year ended 31st March 1993. These norms have been implemented in a phased manner and have stabilized from the year 1994-95.

Reserve Bank of India has issued several circulars regarding these norms applicable to banks. (Copies of the circulars are given in the Appendix this thesis). Some of the earlier guidelines have been modified and improved upon by revised guidelines taking into consideration the representations received from the banks. Most of the areas where there was scope for differing interpretations have been now clarified. However three still exist some areas where there was scope for interpretation which needs further clarifications. These areas are covered in details separately in this thesis. Since no comprehensive material is readily available on this subject, an attempt is made to consolidate various circulars issued by Reserve Bank of India on Prudential Norms and to present them with suitable clarification. Interpretations and with some worked out examples. The author's interpretations have been given on some salient aspects of the circulars.

Due to implementation of the Prudential Norms the "accrual concept" has been changed into "recoverability concept" in recognizing the income on non performing assets. Also uniform practice has been adopted in respect of provision to be made on non performing assets. Also a uniform practice has been adopted in respect of provision to be made on Non Performing Assets (NPAs).

The Reserve Bank of India guidelines on Prudential Norms was originally interpreted by several banks in such a way that the impact of provisioning and Income Recognition was minimal. On the other hand, banks like State Bank of India are following more stringent norm than those stipulated by Reserve Bank of India. Banks are t liberty to adopt more stringent norm than what is stipulated by Reserve Bank of India, but auditors have to ensure that the Income Recognition and Provisioning norms are not diluted by he banks. This thesis is written to help the auditors and bank officials to meet the above requirement.

As per the Banking Regulation Act, the provision for Bad and Doubtful debts has to be made to the satisfaction of the auditors. Also, no banking company can declare a dividend on its shares without writing off all doubtful debts or making provisions for such debts to the satisfaction of the auditors. It is important that the auditors verify and satisfy themselves about the compliance with Reserve Bank of India guidelines on non performing assets since these norms have direct bearing on the profitability of the banks. The specimen of the branch auditors' report of several banks includes conformation from the branch auditor regarding compliance with the Prudential Norms. Further, as per the Long Form

Audit Report (LEAR), auditors have to very and report ht e compliance of Income Recognition and Asset Classification. Statutory central auditors have to give a certificate stating that Income Recognition, Asset Classification and Provisioning have been made as per the guidelines issued by Reserve Bank of India from time to time.

As per the Guidance Note on "Audit of Banks" published by the Institute of Chartered Accountant of India (ICAI) in 1994, it is stated, as under "auditors should examine compliance with those directives of Reserve Bank of India which have a direct and material effect of the balance sheet or the Profit and Loss account of a Bank as part of their annual statutory audit. It must however be recognized that even where the statutory auditors of the bank examines and report on compliance of Reserve Bank of India directives as aforesaid, he is not bound by these directives in forming the opinion bout the true and fair view of the financial statements of the bank. The responsibility for forming and expressing an opinion on the financial statement is that the statutory auditors. He should therefore, exercise his professional judgment in forming an opinion which is appropriate in the facts and circumstances of a particular case".

➤ **<u>Concept of Non Performing Assets:</u>**

An asset which ceases to genera income for the bank is called a Non Performing Assets (NPA). In other words, when a party could not pay interest and /or installment on loans, which remain overdue for more 180 days, then it becomes non-performing. The basic factor to determine whether an account is non performing assets or not is the record of recovery and not the availability of security.

As per Reserve Bank of India circular, gross advance means, all outstanding loans and advances including advances for which refinance has been received but excluding re-discounted bills and advances written off at Head Office level (technical write off). The gross NPA and net NPA area always expressed as a percentage of advances. The percentage of gross NPA to advances includes Interest Suspense account where the bank is following the accounting practice of debiting interest to the customer's account and crediting Interest Suspense account. The following are deducted from gross NPA to arrive at net NPA.

I. Balance in interest suspense account, if applicable;
II. DICGC/ECGC claim received and held pending adjustment;
III. Part payment received and kept in suspense account;
IV. Total provisions held excluding technical write off made at Head Office and provision on standard assets.

Reserve Bank of India has advised that while reporting, banks have to reduce technical write off made at Head Office from gross advance also.

Norms for treating difference advances as non-performing

The following revised norms are adopted for treating different advances as non-performing with effect from the year ended 31st March 2001. An account will be treated as non performing assets if:

Type of Loan	*Condition*	*Period*
a) Term Loan	*Installment of principal and/ or Interest remains overdue for*	*More than 180 days*
b) Cash credit/ Overdue	*Accounts remain 'Out of Order' for*	*-do-*
c) Agricultural Loans	*Installment and/or Interest remains overdue for*	*Two harvest seasons not exceeding two half years*
d) Bills purchased & discounted	*Bills remain 'overdue' and unpaid for*	*More than 180 days*
e) Other accounts	*Facility remains Overdue for*	*-do-*

NPA status has to be worked out from the date the irregularity is established after adding a period of six months in the case of installment.

IDENTIFICATION OF PERFORMING ASSET (STANDARD ASSETS) AS ON MARCH 31, 2005

Cash credit / overdue	Term loan	Bill purchased and discounted	Other accounts
Interest due up to Sept, 30 of year under audit collected before March 31 of the year under audit.	Installment and /or interest due up to Sept, 30 of the year under audit collected before March, 31 of the year under audit.	Bills due up to Sept, 30 of the year under audit collected before Mach, 31 of the year under audit.	Installment and/ or interest up to Sept, 30 of the year under audit collected before March 31 of the year under audit.

IDENTIFICATION OF NON PERFORMING ASSET AS ON MARCH 31, 2005

Cash credit / overdue	Term loan	Bill purchased and discounted	Other accounts
Interest due up to Sept, 30 NOT collected before March 31 of the year under audit. The account remains Out of Order for more than 180 days.	Installment and /or interest due up to Sept, 30 NOT collected before March, 31 of the year under audit.	Bills due up to Sept, 30 NOT before Mach, 31 of the year under audit.	Installment and/ or interest up to Sept, 30 NOT audit collected before March 31 of the year under audit.

When the Prudential Norms on Income Recognition, Asset Classification and Provisioning were introduced in 1992, the concept of 'past due' was incorporated and it was clarified that an amount should be classified as 'past due' when it remains outstanding for 30 days beyond the due date. This practice of giving grace period for term loans was continued up to the year ending March 31st, 2000.

However, due to improvement in the payment and settlement systems, recovery climate, up gradation of technology in banking system etc., it has been decided by Reserve Bank of India to dispense with the past due concept with effect from March 31, 2001. Hence to all account to become non performing assets, cut off date is September 30th of year under audit.

The Cash Credit/Overdraft account will be treated as "Out of Order":

(a) when outstanding balance remains continuously in excess of the sanctioned limit/drawing power (OR)
(b) there has been no credits continuously for six months as at the end of the financial year i.e., March 31 even if the outstanding balance is less than the sanctioned limit/drawing power (OR)
(c) if the credits are not enough to cover the interest debited during the six months ending on the balance sheet date i.e., March 31st.

Prudential accounting norms are sub-divided into 3 pars viz.,

(i) Income Recognition;
(ii) Classification of Assets; and
(iii) Provisioning.

> ➢ ***Income Recognition:***

Income from NPA is into recognized on accrual basis but is booked as income only when it is actually recovered. Hence, once an account becomes NPA, interest income accounted on accrual basis during the year has to be reversed.

Once an account has become NPA, interest accrued should not be credited to the Profit and Loss account but it can be credited to "Suspense Account" by debiting the customers account. Several banks follow this practice. Most of the nationalized banks follow the practice of maintaining a mirror account and the interest due on NPA is recorded only in the mirror account.

Any subsequent recovery in a NPA account should first be appropriated towards interest arrears and balance, if any, to principal. Out of the subsequent recovery, the amount equal to in. arrears received should be reversed by debiting "Interest Suspense Account" and credit Profit and Loss Account by those banks who maintained Interest Suspense Account. Interest partially recovered in NPA accounts can be taken to income account.

State Bank of India, which follows a more prudent accounting treatment, follows the practice of booking interest received on NPA to income account only in the case of sub-standard assets. In the case of doubtful assts, as per State Bank of India guidelines, income could be booked only in consultation with the statutory auditors.

However, it should be ensured that the credits in the accounts towards interest are not out of fresh additional credit facilities or by transfer from another irregular account.

If any Performing Assets as on March 31, of the previous year has become NPA s on March 31 of the current year, all interest income relating to that NPA credited to the Profit and Loss Account of the previous year, to the extent unrealized, should be revered along with current year's unrealized interest. (Unrealized interest means total credit (genuine/normal credit) in the account minus total debit to the account during the year by way of interest).

Hence in the case of all new NPA accounts including bills purchased and discounted identified during the year, interest debited to party's account/interest receivable account and credited to income account less

the aggregate amount of recovered made during the period ended on 31st March of the previous year and 31st March of the current year is to be transferred from income account to interest suspense account. When interest suspense account is not maintained, parties' account is to be credit by debiting income account. This will apply to unrealized interest on government guaranteed accounts also.

Other items of the income such as Exchange, Commission, and Locker Rent etc. are transaction oriented and hence may be recognized as income only on realization. If income such as fees, commission etc is booked in the case of an NPA account on accrual basis, the same should be reversed.

Banks may book dividend income on shares of corporate bodies on accrual basis, provided dividends on the shares have been declared by the corporate bodies in Annual General Meetings and the owner's right to receive the payment is established. Hence if dividend is not declared before finalizing the accounts, it cannot be taken to income account.

In respect of income from Government securities and bonds and debentures of corporate bodies where interest rate are predetermined, income could be booked on accrual basis, provided interest is serviced regularly and is not in arrears.

Banks may book income on accrual basis on securities of corporate bodies/Public Sector Undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government.

The classification of as asset as NPA should be based on the record of recovery. Accordingly, banks need not classify an advance account as NPA merely due to existence of some deficiencies, which are of temporary nature such as:

- Non availability of adequate drawing power temporarily;
- Balance outstanding exceeding the limit temporarily
- Non submission of stock statements and
- Non renewal of the limits on the due date

In respect of accounts where there is potential threats of recovery due to erosion in the value of the security or non availability of security and existence of other factors, say, frauds committed by borrowers etc, the account should be straight away classified as doubtful asset or loss asset as appropriate, irrespective of the period for which it had remained as NPA.

➢ ASSET CLASSIFICATION:

A) STANDARD ASSETS:

This is a performing asset. It does not disclose any problems and does not carry more than normal credit risk.

B) SUB-STANDARD ASSETS:

This is a NPA for a period not exceeding 18 months.

An asset will be treated as doubtful if it has remained in sub-standard category for 18 months instead of 24 months by March 31st 2001. Additional provisions required due to reduction of the period from 24 month to 18 months have been provided in a phased manner in two years. 50% of assets which has become doubtful on account of reduction of the period to be provided by March 31st 2001 and the balance 50% of provision together with additional provision to be made for that year to be provided by 31st March 2002.

Due to this change, for the year ended 31st March 2001 the provision has to be calculated for the accounts treating it under Sub-standard category for 24 months. Separate working of the provision has to be made keeping the advance under sub-standard category for 18 months, and doubtful category after that period. The infact will be that, after 18 months, the amount will be transferred to doubtful category where higher provision of 20% has to be made. The difference between the provisions under these two periods has to be distributed equally over two years starting with the year ended 31st March 2001.

DOUBTFUL ASSET:

This is a NPA for a period exceeding 18 months.

LOSS ASSET:

This is a NPA which has been identified as a loss asset by the bank or internal or external auditors or Reserve Bank of India inspectors. The bank may incur 100% loss in such cases. If there is a potential threat of recoverability due to either substantial erosion in the value of the security or non-availability of security or due to any fraudulent act or omission on the part of the borrower, such accounts also may have to be classified as loss asset.

EXEMPTED ASSETS:

The advances against the following types of securities are totally exempted from Asset Classification, Income Recognition and Provisioning:

a) Banks' own term deposits including recurring Deposits
b) National Saving Certificates
c) Surrender value of Life insurance policies
d) Indira Vikas Patras
e) Kissan Vikas Patras

Interest debited to the advances against eh above securities whether recovered or not can be taken to income account provided adequate margin is available.

The above exemption is not to be extended to the loans against India Development Bonds and NRI Bonds. Further, it may be noted that advances against gold ornaments and Government Securities are NOT exempted from Income Recognition and Provisioning norms.

Advance against bank's own term deposits/recurring deposits, NSCs, life insurance polices and Kissan Vikas Patras will be treated as 'Standard Assets' provided the outstanding is within the value of the security even though interest debited for two quarters (180 days) are not collected.

The identification of NPA is to be done on the basis of the position as on the date of balance sheet. Hence advances which have been regularized by repayment of outstanding interest and installment of principal before the balance sheet date need not be treated as NPA, even though default in the accounts persisted for more than 180 days.

A term loan will be treated as NPA if interest/installment remains 'overdue' for a period of more than 180 days.

It should be ensured that the tem loan account is not serviced by transfer from another account which is irregular. There is no harm in crediting the interest and installment of a term loan by transferring from a Cash Credit/Overdraft account of the same borrower, provided the cash credit/overdraft is within the drawing power even after debiting the term loan interest/installment.

Regularization/Closure of the Account after the Balance Sheet date:

As per the guidelines, the statuses of the account have to be analyzed on the Balance Sheet date to determine the NPA status. Hence, regularization/closure of the accounts after the year need not be

considered and provision already made need not be reversed. The bank management may take a view that additional provision, as on the year ending date is not required to be made in NPA accounts where the accounts are fully closed after the Balance sheet date but before finalization of the accounts. This view has got some merit and the auditor has to form an opinion after studying the particular account. However, proper disclosure has to be made in all such cases.

Steps for identification of NPAs for term loans:

1. Where installment amount is fixed excluding interest:

   a) If the balance outstanding as on 30th September of the year under audit less amount recovered from October 1 to March 31st of the year under audit is more than the sanctioned limit, there is arrears of interest for more than 180 days and hence the account will become NPA.

   b) If the above worked out amount is less than the sanctioned limit, then arrears of installment has to be found out as follows:

      (i) from the balance outstanding in the account as on September 30th of the year under audit, deduct the remittances made from October 1st to March 31st of the year under audit.

      (ii) from the amount of advance deduct the installment amount overdue up to September 30th of the year under audit. If the amount worked out as per (a) above is more than the amount worked out as (b) then, the account will become NPA, (refer illustration in Para number 47).

2. Term loan where installment is loaded with interest:

In several cases, banks fix repayment of term loan together with interest. The following procedure has to be followed in determining the non-performing advances in such situations.

If the balance outstanding as on September 30th of the year under audit less subsequent recoveries from 1st October to March 31st of the year under audit is more than the sanctioned limit, there is arrears of interest for more than two quarters and hence it is NPA. If the balance outstanding is less than the sanctioned limit, arrears of instalment has to be worked out as follows:

(a) find out the number of installment due as on 30th September of the year under audit.
(b) find out the total amount actually remitted by the borrower from the date of opening of the account till 31st March of the year under audit.
(c) divide the amount so arrived by the installment amount fixed including interest. Fractions can be ignored.
(d) if the number of installments worked out as per (a) above is more than the number of installments actually paid as per (c) above , the account is NPA , since interest is overdue fore more than 180 days. (refer illustration in Para number 48).

Cash credit or overdraft accounts should be treated as NPA if the account remains “Out of Order”, for more than 180 days.

Banks may not classify an advance account as NPA merely due to existence of some deficiencies, which are of temporary nature such s non availability of adequate drawing power, balance outstanding exceeding the limit, non submission of stock statements and the non renewal of the limit on the due date. However when there is a threat of loss or the recoverability of the advance is in doubt, asset should be classified as NPA.

If the accounts of the borrowers have been regularized before the balance sheet date by repayment of overdue amounts through normal source, (i.e. not by sanction of additional facilities not justified by the genuine needs of the borrower or transfer of funds from another irregular account) the account need not be treated as NPA.

It has to be ensured that the account remains in order subsequently and a solitary credit entry made in the account on or before the balance sheet date which extinguishes the overdue amount is not reckoned as the sole criteria for treating the account as a standard asset.

The credit in the account means genuine credit. A credit by way of a cheque which is returned unpaid should not be considered.

The definition of “Out of Order” is given in the beginning of this thesis. As per this definition, an account can become “Out of Order” and “non-performing” under three situations which are given as (a), (b) and (c) in the definition. A cash credit / overdraft account will become NPA if it is overdrawn continuously for two quarters or if there are no credits for the last six months of the financial year. If the balance is brought within the drawing power at least once during the period it cannot be considered as continuously overdrawn. A wider meaning may be applied to the last situation (c) where a Cash credit account becomes “Out of Order” and

hence NPA when credit are not enough to cover the interest debited during the six months as on the Balance sheet date. In other words, in an account which is within the drawing power, if the interest up to September quarter is paid before March 31 of the year under audit, the account need not be considered as NPA even though the credits are not enough to cover the interest debited during the last six months. However, if the cash credit account is inoperative for the last six months of the year under audit, such accounts may be classified as NPA even if it is within the drawing power.

Bills purchased and discounted will be treated as NPA, if the bills remain overdue or unpaid for more than 180 days. In the case of usance Bills, the due date of the bills is the expiry date of the usance period and the period they were overdue can be calculated from that date. Further, overdue interest should not be charged and taken in income account in respect of overdue bills unless it is realized.

Banks generally fix a grace period of 7 to 15 days for treating the cheque purchased and bills purchased and discounted to become overdue. Once the bills or hundi have become NPA, the above grace period need not be considered and six months have to be reckoned from the due date of the bill. In the case of cheque purchased account which has become NPA, the irregularity starts from the date of purchasing of the cheque.

It is possible that one customer may be enjoying a total bill discounting limit. Assuming that if one bill of the customer is not paid even after six months of the date of purchase, but, total outstanding of all bills (including the NPA bill) put together is within the limit sanctioned, still such bills have to be treated as NPA. Each bill has to be treated as a separate limit and will become NPA if not paid within 180 days the due date.

The question now arising is, if one bill has become NPA, whether subsequent bills discounted even if not due for payment will become NPA, since when one facility given to a borrower is NPA all other facility given to the same borrower has to be treated as NPA. A broader view may be taken if the irregularities are of a temporary nature.

➢ ***Provisioning:***

a) Standard assets	A general provision of a minimum 0.25% has to be made from the year ended March 31, 2000.
b) Sub-standard assets	10% of outstanding balance after

deducing interest debited and not collected during the year together with unrealized interest of the corresponding previous year incase of new NPAs identified during the year. (DICGC/ECGC cover will not be available for sub-standard assets)

c) Doubtful assets

Age of Assets	Provision to be made
1. Doubtful up to 1 year. (Non performing for 1 ½ to 2 ½ years) (D1)	100% of unsecured portion of advance after DICGC/ECGC cover and 20% of value of tangible security.
2. Doubtful for more than 1 year but up to 3 years. (Non performing for 2 ½ to 4 ½ years) (D2)	100% of unsecured portion of advance after DICGC/ECGC cover and 30% of value of tangible security.
4. Loss asset	100% of outstanding balance after deducting interest debited and not collected held in 'Suspense A/c' together with DICGC/ECGC claim available.

An advance that has become NPA will automatically become D3 after 4½ years with effect from March 31st, 2001 due to the reduction of the period under sub-standard category to 18 months from 24 months.

Net worth of the borrower/guarantor should not be taken into account to find out shortfall insecurity. If the value of the tangible security is more than the outstanding balance, then provisioning has to be made for the outstanding balance only after deducing Interest suspense and DICGC/ECGC cover.

If the total realizable value of the security is less than Rs 1 lakhs or less than 10% of the outstanding balance, then it is prudent to treat the account as a loss asset.

The 'Floating Provision' or the excess provision made by the bank on identified accounts could be set off against provision required to be made under prudential guidelines.

There is no special treatment now for accounts when balance is below Rs.25, 000/- and banks should classify such advances also into different categories, viz., standard. Sub-standard, doubtful and loss assets and make appropriate provisions. In the case of priority sector advances granted under SEEUY, Small Loans, and IRDP AND DRI which have become NPA, the primary security need not be taken into account unless the latest certificate from the branch manger is obtained for having verified the security.

Reconstruction and Revaluation of Assets:

Reserve Bank of India has made some modifications and some relaxation to the original guidelines regarding re-schedulement / re-negotiation of account and applicability of NPA status. The issue has to be analyzed in three situations as explained below:

a) Re-schedulement before commencement of commercial production:

An account, which has not become NPA, re-schedulement can be done before the commencement of production or installment becomes due for payment as per original terms. An account which has not become NPA re-schedulement can be done before the commencement of production or installment become due for payment as per original terms and such accounts will continue to be Standard Assets. In such cases, NPA status has to be considered with reference to the revised terms.

b) Re-schedulement of advance immediately after commencement of commercial production for units having temporary bottlenecks:

Reserve Bank of India has issued a revised circular dated 10.05.1999 regarding the re-schedulement of loan and concept of commencement of commercial production.

It has been decided to leave for the consideration of the Board of Directors of the bank whether unit has stabilized commercial production and whether there is a need for re-scheduling of the loan. In order to arrive at a decision as to whether the unit/project has achieved regular commercial production, the main guiding factor would be whether the unit has achieved cash break even in order to service the loan. As per the new guidelines, "if in the opinion of the bank, the bottleneck in achieving regular commercial production is of a temporary nature, not indicative of any long term impairment of the unit's economic viability and is like to achieve cash break even if some time is allowed, the bank may re-schedule the loan and treat the asset as standard. However the lead time would not normally exceed one year from the schedule of

commencement of commercial production as indicated in the terms of sanction.

In respect of credit facilities sanctioned under consortium arrangements, the decision as to whether the borrowing unit has achieved a regular commercial production and there is a need for re0scheduling may be taken up by the lead institutions or lead bank and other participating institutions/banks may follow the same".

These new guidelines gives relaxation to the norms, and now if the re-schedulement is made in genuine cases by the management, by allowing further time not more than one year after starting commercial production, the account will continue to be treated as Standard Asset. It is assumed that this relaxation will be made applicable to financial institutions also.

The "evergreening" of the balance sheet by rescheduling and restructuring probable NPA account is not in line with Reserve Bank of India guidelines on prudential norms.

c) NPA status of normal re-scheduled advances:

An advance which has become NPA and re-scheduled/re-negotiation after commencement of commercial production should be classified as sub-standard and should remain in that category for a minimum period of one year of satisfactory performance of re-negotiated or re-scheduled terms before it is upgraded as a standard asset.

As per Reserve Bank of India guidelines, all rescheduled/renegotiated NPA's where rescheduling/re-negotiation is done after the commencement of production or after the installments become due as per original terms should be classified as per the original status before re-schedulement.

In other words, in an account, which has not become NPA, where reschedulement can be done before the commencement of production or installment becomes due as per original terms and the NPA status has to be considered with reference to the rescheduled terms.

The following issues arise:

a) In cases, where re-schedulement is allowed where production/ commencement of business activity is not started, and advance have not become NPA on the date of re-schedulement, is it in order to fund the arrears interest along with re-schedulement of Term

Loan? In other words, is it necessary to provide for the arrears interest?

b) Whether re-scheduling the account two or three times on the ground of non-commencement of commercial production justifiable?

c) Whether re-schedulement is permitted treating the account as standard asset in cases where advances re not made to industrial units? In other words, whether reschedulement, extending moratorium period is permitted in real estate/housing projects in cases where the projects are not completed.

Reserve Bank of India circulars does not prohibit funding of interest arrears incases where the advance has not become NPA and where reschedulement is done before starting production. However, cases are reported where Reserve Bank of India inspectors during the inspection of the bank, take a view that even in such cases, the funded interest has to be provided for. Hence, it is advisable that the auditors take an independent view considering the overall situation and operation of the account and give necessary disclosures to that effect in the Auditor's report.

In cases where production has started but installments have not become due, re-schedulement may be done treating the account as standard asset.

Regarding further re-schedulement, it may be done in genuine cases, provided, it is made within one year of the original schedule of commencement of production and the management of the bank is convinced about the necessity thereof and the same is approved by the Board of the bank. Such accounts also may be treated as Standard assets.

Housing projects are generally taking more time to complete than what is originally fixed and in deserving cases, subject to the approval of the Board, re-schedulement can be made and such accounts may also be treated as Standard provided, Board is convinced about the temporary bottlenecks of the project. However, in such cases, it is advisable to suggest for making provision of the unrealized interest. This issue is not yet clarified by Reserve Bank of India and auditor has to take an independent view in this matter.

The role of the auditor in the entire above situation is very important and he has to assess such accounts and consider whether it is prudent to make re-schedulement /re-placement by extending moratorium period.

Strengthening Capital and Supervision by Banks:

In respect of accounts where there are potential threats to recovery on account of erosion in the value of security or non-availability of security and existence of other factors, for e.g., fraud committed by borrowers, etc such accounts should straight away be classified as doubtful assets or loss asset as appropriate, irrespective of the period for which it has remained as NPA.

In such situations, it will not be prudent for banks to classify them first as "Sub-standard" and then as "Doubtful" after expiry of two years from the date the account has become NPA. The factor to be considered in such situations is whether there is a threat of loss or whether the recoverability of the advance is in doubt. Just because a fraud is committed, the status need not be downgraded if his recoverability is not in doubt. However, it is advisable to treat all fraud cases as NPA.

Up gradation of NPA within the Doubtful status or upgrading it from doubtful to sub-standard shall not be made due to subsequent recoveries unless the account is regularized and comes out of the NPA status. In other words, the date on which an account has become irregular shall not be changed due to subsequent recoveries, till regularization of the account. This point is not specifically clarified in the Reserve Bank of India circulars. However, Reserve Bank of India has written to some banks individually clarifying that up gradation within NPA status within doubtful category or from doubtful to sub-standard category, considering the improvement in the recovery position which is against the spirit of the Reserve Bank of India guidelines.

Central Government Guaranteed advances are exempted from provisioning norms unless the Central Government repudiates the guarantee. But income reorganization will apply if the advance is not serviced for more than 180 days.

However, the State Government guaranteed advances where guarantee has been invoked and has remained in default for more than 180 days, and which has turned sticky are now to be classified as NPA as per the existing prudential norms with effect from 1st April 2000. Provision for the existing old State Government guaranteed advances which are invoked should be made in 4 years with a minimum of 25% from the year ending March 2000.

- **Risk Weight on Securities:**

A loan given for purposes such as education, agricultural plantations, new projects etc. where moratorium/gestation period is allowed as per original sanction, payment of interest becomes due only after the said period is over. In the case of loans where re-payment is fixed in lump sum with interest, the account will become NPA only after six months (180 days) from the due date fixed as per the sanction, even if quarterly interest debited in the account is not remitted periodically.

Staff Accounts can be treated as Standard Assets as the monthly installments will be recovered regularly and interest charged on such accounts can be recognized as income for the year.

In cases where a borrower is having several facilities, all the facilities granted to a borrower will have to e treated as NPAs and not the particular facility or part thereof which has become irregular. This is because classification of the accounts as performing asset or non-performing assets should be borrower-wise and not facility or account-wise. If a borrower has one facility as doubtful and two facilities as standard assets then the other two facilities may also be treated as doubtful. For example, if a term loan account of a borrower is doubtful and the cash credit facility sanctioned to him is regular, both the facilities, viz., term loan and cash credit may treated as doubtful.

In such cases, NPA at the lowest category of any one account may be applied to other accounts of the same borrower also. However, this clubbing provision is not applicable to advances granted to ceded Primary Agricultural Credit Societies (PACS)/Farmers Service Societies (FSS) where the advance is given under lending scheme.

However, some banks are of the opinion that, if a performing asset of a borrower has to be treated as non-performing because of the fact that one account of the same borrower is NPA in the doubtful category, the performing account need only be treated as sub-standard and not as doubtful.

The Reserve Bank of India circular has not explained what type of facilities given to a borrower has to be considered together as NPA account if one facility has become NPA. It is possible hat one account may be in the proprietor's name, another advance in the partnership name where the borrower is the Managing partner and third advance in the name of the company where the original borrower has a substantial interest since company is a separate legal entity there is no justification in considering it as the same borrower. In the case of partnership firm if the management and control of the partnership business is with the

original borrower in such cases it is justified in clubbing the same for NPA purpose, with that of the account of the borrower of the proprietary business. In the case of two partnership firms enjoying facilities with the same bank, with one or two common partners and one or two outsiders, if one account has become NPA the other account need not be treated as NPA.

In respect of consortium advance, each bank may classify borrower account according to its own record of recovery and other aspects having a bearing on the recoverability of the advance, as in the case of multiple banking arrangements. The status of the account with other consortium members need not be considered. However it is clarified that in the case of re-schedulement of advances after commence of production the lead banker's decision has to be accepted by the consortium members.

In respect of allocated limits, the classification made by the allocation branches should be adopted by the allocate branches. A certificate has to be obtained from the auditors of the branch where the main facility is operated regarding the status of the account.

Advance to units under nursing where the accounts are rescheduled cannot be upgraded immediately thereafter. The asset classification made prior to the rescheduling should be continued for at lease one year (four quarters) in a satisfactory condition. In the case of all rescheduled renegotiated NPA advances, where re-scheduling/ renegotiation is done after commencement of production or after the installment become due as per original terms, should be classified in the original status before re-schedulement as Sub-standard / Doubtful and should remain in such category for at least on year of satisfactory performance under renegotiated/re-scheduled terms.

As per the original guidelines, additional credit facilities sanctioned to unit under rehabilitation package approved by BIFR/term lending institutions, provision need not be made for a period of one year from the date of disbursement. Considering the recommendations received from banks, it has been decided by Reserve Bank of India that from the year ending March 31, 2000, no provision, need be made for a period of one year in respect of additional credit facilities granted to SSI units which are identified as sick and where rehabilitation package/nursing program have been drawn by the bank themselves or under consortium arrangements.

Relaxation is given for determining NPA status in the case of agricultural advances. Reserve Bank of India has clarified that advances granted for agricultural purposes may be treated as NPA if interest/installment of principal remains unpaid, for two harvest seasons but for a period not

exceeding two half years. The past due concept is not applicable from the year ended 31.03.2001.

The relaxation given to agricultural loans is intended only for crop loans and not for agricultural term loans. However this point is not clarified in Reserve Bank of India circular. Normally, crop advance for paddy is given for six months. Other crop loans including sugar cane are normally given for one year. Hence the NPA date has to be worked out after adding six months from the due date. Vide circular dated 28th December 1998, Reserve Bank of India has given exemption to agricultural loans affected by natural calamities, where concession or re-schedulement of term loans as well as fresh short term loans are sanctioned. The same can be treated as current dues and need not be classified as NPA's and the asset classified will thereafter be governed by the revised terms.

As per the circular dated 21.10.1999, Reserve Bank of India has clarified that in respect of agricultural advances as well as advances for other purposes granted by banks to ceded Primary Agricultural Credit Societies (PACS)/Farmers Service Societies (FSS) under the on-lending system, only that particular credit facility granted to a PACS/FSS which is in default for a period of two harvest seasons (not exceeding two half years)/two quarters, s the case may, will be classified as NPA and not all the credit facilities sanctioned to a PACS/FSS. However, other direct loans and advances if any, granted by the bank to the member borrower of a PACS/FSS outside the on-lending arrangement will become NPA even if one of the credit facilities granted to the same borrower becomes NPA.

Some banks are given gold loans as agricultural term loan with a moratorium of 24 months. They further take the advantage of NPA period of 12 months (two half-years) from 24th month to determine the NPA status. The effect will be that such accounts, even if not serviced, will not become NPA for 3 years, which is against the spirit of Reserve Bank of India circular.

Advance against gold ornaments are not exempted from provisioning requirements. However, in the case of gold loans, 180 days can be worked out from the expiry date of the loan period which is normally 9 to 12 months. This procedure can be adopted only if, as per the agreement, the interest or installment is not due for payment before the expiry date. The ac will become NPA after 180 days from the date of expiry of the loan period.

As per Reserve Bank of India circular dated 29.01.1997, in respect of accounts where there is potential threat to recovery on account or

erosion in the value of security or non availability of security and existence of other factors such as frauds committed by the borrower, it will not be prudent for banks to classify them first as Sub-standard and then as Doubtful after the expiry of 18 months from the date the account becomes NPA. Such accounts should be straight away classified as Doubtful or Loss assets, as appropriate, irrespective of the period for which it has remained as NPA.

This direction of Reserve Bank of India has led to divergent views in determining provision amount. The statutory auditors has to carefully analyze the situation and form his opinion in determining the provision in the case of accounts where fraud has taken place and the value of the security is considerably eroded. The down gradation of the status of NPA of doubtful or loss asset is dependent upon the seriousness of the fraud and also the reliability of the security. The divergence in views arises mainly at the time of Reserve Bank of India inspections where Reserve Bank of India inspectors generally takes a rigid view. It may be ensured that all fraud cases irrespective of the fact whether it is recoverable or not, may be identified as NPA.

The questions that may arise are as follows:

01. An account which is fully secured and reliability is not in doubt but is reported as fraud, whether the account has to be considered as NPA and status downgraded?
02. Where primary security is fully eroded but collateral security is available, whether such accounts is to classify as NPA and downgraded?

It is suggested to classify of the accounts in the above situations as NPA. The NPA status may be determined depending upon the situation.

As per Reserve Bank of India circular dated 07/02/2000, it has been clarified that in situations where the payment is made by the importer to the bank abroad but the bank is unable the remit the amount to India due to unforeseen circumstances such as war, internal strife, UN embargo etc, the prudential norms relating to income recognition, asset classification and provisioning may be made applicable after a period of one year from the date the amount was deposited by the importer in the bank abroad. But the lending bank should establish though documentary evidence that the importer has already cleared the dues in full by depositing the amount in the bank abroad before it turned into NPA in the books of the bank.

Banks should make 100% provision for net debit balance position; in inter branch accounts arising out of un-reconciled entries (both debit

and credit) outstanding for more than 2 years as on 31st March every year. As per Reserve Bank of India circular dated 10/01/2000, the time lag has been reduced from 3 years to 2 years from the accounting year ending on March 31st 2001. Banks should maintain category wise (head wise) accounts for various types of transactions put through inter branch accounts and netting has to be done category wise. As on the balance sheet date, banks should segregate debit and credit entries remaining un-reconciled for more than 3 years and arrive at the net position category wise and 100% provision to be made on aggregate debit balance. It should be ensured that net debit in one category is not set off against credit in another category.

Reserve Bank of India does not specify the order of appropriation of the recovery in a NPA account. Hence it is left to the discretion of the bank management to decide the order of appropriation. The NPA account is given below:

a) Interest debited and not collected (arrears interest);
b) Current interest;
c) Arrears principal and
d) Current principal

Several banks have opted out of the DICGC and it has to be verified whether the cover is available for the whole year. Otherwise only the amount actually received need be considered.

From 01/04/1994 onwards, only 50% of the amount lying in the account covered by DICGC (limited to Rs.20 lakhs) is available. The claim available under ECGC (Packing Credits) is 66.67% of the total amount of loss. For whole turnover post shipment guarantee the claim available is 85% of loss where comprehensive risk is available and 60% for others.

In the case of advances guaranteed by ECGC/DICGC, provision should be made after considering DICGC/ECGC cover against the said facility. DICGC/ECGC cover is to be calculated only after deducting the value of the securities (Primary and Collateral) from the gross liability. For computation of unsecured amount against which proportionate DICGC cover is required to be set off, due consideration must be given for the securities on realization of which are to be shared by the banks and DICGC. DICGC has made substantial changes in the scheme of coverage of risks by the banks which is made applicable from the year 1995-96 onwards as indicated below:

a) Banks can lodge new claims only after the account is written off in the books of accounts on the orders of the competent authority.

b) DICGC Guarantee shall cover only the principal amount sanctioned by the bank.

c) In the case of term loans, the Guarantee will be for the principal amount outstanding as on the date of write off.

d) In the case of cash credit / overdue, the Guarantee cover shall be based on the amount outstanding within the regular limit sanctioned. The liability of DICGC shall be subject to a sharing pattern between the DICGC and the bank and shall also be subject to a ceiling as prescribed by DICGC.

e) DICGC will not entertain the claim in any account if the recovery (excluding adjustment of subsidy) is less than 25% of the total debits in the account on the date of write off of such amount.

f) DICGC may allow relaxation in the above situation when the borrower has expired or in any other ground which DICGC considers appropriate.

g) The claim should be lodged with DICGC within one year from the date of write off the account in the books.

The ECGC cover available has to be worked out after first deducing realizable value of the security from the balance outstanding in the account.

In the case of banks which have opted out of DICGC, the actual claim received can only be considered after first deducing the value of security.

It has been clarified that the claims settled by ECGC and kept in a separate current account due to technical reasons could be allowed to be adjusted against the dues outstanding in the respective accounts.

An example for calculation of ECGC claim is worked out below:

(Rupees in lakhs)

	Amount	Provision %	Provision Amount
Net amount outstanding (doubtful asset)	4.00		
Less: Realizable value of security (primary & collateral)	1.50	50	0.75
Balance	2.50		
Les: ECGC cover @ 66.67%	1.67		

Balance unsecured portion	0.83	100	0.83
Total Provision required			1.58

It is possible that the DICGC/ECGC claim might have been received. In such cases, the proportionate value of the Security realized subsequently and proportionate amount collected after settlement of the claim have to be returned to DICGC/ECGC.

Assets Liability Management:

Asset Classification and provisioning norms are made applicable to leased assets also. Vide circular dated 17th July 1999, Reserve Bank of India has clarified that banks should follow the 'Guidance note on Accounting of Leases; issued by the Institute of Chartered Accountants of India'. As per Reserve Bank of India guidelines, the leased assets have to be fully written of during the primary lease period.

The net lease rentals (finance charge) on the leased assets accrued and credit to the income account before the asset became non-performing, and remaining unrealized, should be reversed or provided for in the current accounting period.

The term 'net lease rentals' would mean the amount of finance charge taken to the credit of profit and loss account and would be worked out as gross lease rentals adjusted by amount of statutory depreciation and lease equalization account.

Provisioning norms for non-performing leased assets:

<table>
<tr><td>Sub-standard asset</td><td colspan="2">10% of the net book value</td></tr>
<tr><td>Doubtful asset</td><td colspan="2">a) 100% of the extent to which the finance is not secured by the realizable value of the leased asset; realizable value to be estimated on a realistic basis.

b) Over and above (a) above, depending upon the period for which the asset had been doubtful the following provision on the net book value of the secured portion should be made:</td></tr>
<tr><td></td><td>Period
Upto 1 year
1 to 3 years
More than 3 years</td><td>% of provision
20
30
50</td></tr>
<tr><td>Loss Asset</td><td colspan="2">The entire asset should be written off. If for any reason, asset is allowed to remain books, 100% of the net book value should be provided for.</td></tr>
</table>

Net book value has been defined as follows:

Gross book value of a fixed asset is its historical cost or other amount substantiated for historical costs in the books of account or financial statements. When this amount is shown net of accumulated depreciation it is termed as net book value.

It has now been clarified by rib that treatment and accounting of standard assets is to be made as follows:

I. The general provision of 0.25% on standard assets should be made on global portfolio basis and not on domestic advance alone.
II. Provision towards standard assets need not be netted from gross advances but shown separately as 'Contingent provision against Standard Assets', under "Other Liabilities and Provision-Others" in schedule V of the Balance Sheet.
III. The above contingent provision will be included in Tier II capital.
IV. However, the provision on standard assets together with other 'general provisions/loss reserves' will be admitted as Tier II capital up to a maximum of 1.25% of the total risk weight assets.

Up to the year ended March 31st, 1999 banks were required to show advance against Book Debts under item No: B (i) "Secured by tangible assets" of Schedule No:9. Although such advances are secured, it is likely that it may not be fully secured by tangible assets. Hence, from the year ended March 31st, 2000 onwards, banks have been advised to indicate separately in Schedule No:9 that item B (i) includes "Advances against Book Debts" as shown below:

Advances - (Schedule No.9)

B (i) Secured by tangible assets *
(* Includes advances against Book Debts)

Valuation of Investments:

Banks maintain "Investment Fluctuation Reserve Account" which is utilized to meet in further the depreciation requirement on investment in securities. It has since been clarified by Reserve Bank of India that the extra provision needed in the event of a depreciation in the value of the investment should be debited to the Profit and Loss account, and if required, an equivalent amount may be transferred from the "Investment

Fluctuation Reserve Account: to the profit and loss account as a "below the line" item after determining the profit for the year.

When exchange movements of Indian rupee turn adverse, the outstanding amount of foreign currency denominated loans (where actual disbursements were made in Indian rupees), which becomes overdue, goes up correspondingly with its attendant implications of provisioning requirements. It has been decided that such assets should not normally be revalued. In case such assts need to be revalued as per requirement of accounting practices or for any another requirement, the following procedure may be adopted.

a) The loss on account of revaluation has to be booked in the bank's profit and loss account;

b) Besides the provisioning requirement as per Asset Classification, the banks should treat the full amount of the Revaluation Gain relating to corresponding assets, if any, on account of Foreign Exchange fluctuation as provision against the particular asset.

Under this arrangement, the institutions/the banks financing infrastructure projects will have an arrangement with any financial institutions for transferring to the latter the outstanding in respect of such financing in their books on a pre-determined basis.

Income Recognition and Provisioning will apply in the case of the lending institutions till it is actually taken over by the taken over institutions. As and when the asset is taken over by the taken institutions, the corresponding provisions could be reversed by the lending institutions. However, the taken over institutions, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

All loans and advances granted to the bank's own staff should be shown under "Other Assets", if it is non interest bearing, in schedule No.11 of the balance sheet with a suitable footnote indicating the aggregate quantum thereof. It has since being clarified by Reserve Bank of India that interest bearing loans and advances granted to the staff should be included under "Advances" in schedule No.9 of the balance sheet. From the year ending March 31st 2001, banks should assign 100% risk weight to all type of loans and advances to banks own staff, however, loans and advances to staff against term deposits, Life insurance polices, National Saving Certificate, Indira Vikas Patras, Kissan Vikas Patras where adequate margin is available, may be assigned zero risk weight.

The exposure ceiling in respect of individual borrowers had been reduced from 25% to 20% of bank's capital funds effective from April 2000. Banks re advised that where the existing level of exposure as on October 31st, 1999 is more than 20%, they should reduce the exposure to 20% of capital funds over a two year period (by end of October 2001).

Vide circular dated September 23rd, 2001, Reserve Bank of India has directed all scheduled commercial banks operating in India (including foreign banks) to transfer not less than 25% of the net profit (before appropriation) to the Reserve Fund with effect from the year ending March231st, 2001. Such transfer of profit to the reserve fund to be made after making adjustment / provision towards bonus to staff.

It has been directed by Reserve Bank of India that within the overall exposure to sensitive sectors, a banks' exposure to capital market by way of investment in shares, convertible debentures and units of mutual funds (other than debt instruments) through primary or secondary market should not exceed 5% of the banks total outstanding domestic credit (excluding inter-bank lending and advances outside India) as on March 31st of the previous year. Investment in shares and debentures / bonds should be reckoned for the purpose of arriving at the Prudential Norms of single borrower and borrower-group exposure ceilings.

From the year ending March 31st, 2001, all banks should charge depreciation on computers on a straight-line method at the rate of 3333% per annum. This would enable the banks to replace the outdated/obsolete computers within a period of three years.

Guidelines for Classification and Valuation of Investment by Banks:

1. Vide circular number DBOD BP.BC.32/21.04.048/2000-2001 dated 16/10/2000, Reserve Bank of India has completely modified the earlier guidelines for classification and valuation of investments.

2. At present, investments of banks comprise SLR securities and non-SLR securities. The classification of the investments in the balance sheet, for disclosure, is under six groups viz., (i) Government securities (ii) Other approved securities (iii) Shares (iv) Debentures & Bonds (v) Subsidiaries/joint ventures (vi) Others (CP, Mutual Funds Units, etc.). While the first two classifications represent the bank's investments in SLR securities the other four represent the non-SLR securities. Banks were earlier advised that for the purpose of valuation.

a. The investments of banks in SLR securities should be bifurcated into current' and 'permanent', with the prescription that the 'current' investments are not less than 75% of the total SLR securities, excluding the new banks set up after 1993 in the private sector which were required to include their entire SLR investments under 'current' category and

b. 'Current' category of SLR investments and the entire portfolio of non-SLR investments should be marked to market.

Reserve Bank of India has also been issuing detailed guidelines to be followed for valuation of the investments and making them to market every year. Besides, to facilitate valuation of investments which are not quoted, YTM rates for Government securities of different maturities, as on March 31, are also being issued annually.

Review

With the introduction of prudential norms on capital adequacy, income recognition, asset classification and provisioning requirements the financial position of banks in India has improved in the last few years. Simultaneously, trading in the securities market has improved in terms of turnover and the range of maturities dealt with. In view of these developments and taking into consideration the evolving international practices, an informal Working Group in the Bank has reviewed the existing instructions on the classification and valuation of the investments portfolio. The guidelines on classification and valuation of investment. By banks have been revised on the basis of the recommendations of informal Group to bring them in consonance with the best international practices.

Revised Guidelines:

The highlights of the revised guidelines are given below:

- The revised Guidelines will be effective from the half-year ended September 30, 2000.
- The banks are required to classify their entire investments Portfolio as on September 30, 2000, under three categories viz., Held to Maturity', 'Available for Sale' and 'Held for Trading'
- In the balance sheet, the investments will continue to be disclosed as per the existing Six classifications viz. (i) Government securities (ii) other approved securities, (iii) Shares (iv) Debentures & Bonds

(v) Subsidiaries/joint ventures (vi) Others (CP, Mutual Funds Unit, etc).

- The investments under the Available for sale and Held for Trading Categories should be marked to market periodically or at more frequent intervals.
- The investments under the Held to Maturity category need not be marked to market as in the case of 'Permanent' securities at present.
- Classification of investments, shifting of investments among the three categories, valuation of the investments, methodology for booking profit/loss on sale of investments and providing for depreciation should be in accordance with the guidelines given below.
- The risk-weights assigned to the various securities at present, including those for 'market risk', would remain unchanged.

The classification of the existing investments among the three categories may be done at the book value of the respective securities as on September 30, 2000. Subsequent valuation of the securities included under the 'Held for Trading' and The 'Available for Sale' categories may be carried out as specified in the revised Guidelines. The first such revaluation may be done as on September 30, 2000 for the securities under the 'Held for Trading' category. Securities under the Available for Sale' category may also be revalued as on that date if the Bank proposes to revalue this category at intervals more frequent than 'annual intervals'.

Banks should formulate an investment Policy with the approval of their Board of Directors to take care of the requirements on classification, shifting and valuation of investments under the revised guidelines. Besides the policy should adequately address risk management aspects, ensure that the procedures to be adopted by the banks under the revised guidelines are consistent, transparent and well documented to facilitate easy verification by inspectors and statutory auditors.

Guidelines for Classification and Valuation of Investment by Banks

A) Categorization:

1. The entire investment portfolio of the banks (including SLR securities and non-SLR Securities) will be classified under three categories viz., Held to Maturity', 'Available for Sale' and 'Held for Trading'. However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications viz., (i) Government securities (ii)

other approved securities, (iii) Shares (iv) Debentures & Bonds (v) Subsidiaries/joint ventures (vi) Others (CP, Mutual Funds Unit, etc).
[Definition: The securities acquired by the banks with the intention. To hold them up to maturity will be classified under 'Held to Maturity'. The securities acquired by the banks with the Intention to trade by taking advantages of the Short-term price/Interest rate movements will be classified under Held for Trading. The securities which do not fall within the above two categories will be classified under 'Available for Sale'].

2. Banks should decide the category of the investments at the time of acquisition and the decision should be recorded on the investment proposals.

B) Held to Maturity:

1. The investments included under "Held to Maturity" should not exceed 25% of the Bank's total investments. The banks may include, at their discretion, under held to Maturity category securities less than 25% of total investment.

2. The following investments will be classified under 'Held to Maturity' but will not be counted for the purpose of ceiling of 25% specified for this category:
   ii. Re-capitalization bonds received from the Government of India towards their re-capitalization requirement and held in their investment portfolio. This will not include re-capitalization bonds of other banks acquired for investment purpose.
   iii. Investments in subsidiaries and joint ventures) A joint ventures would be one in which the bank, along with its subsidiaries, hold more than 235% of the equity].
   iv. The investments in debentures/bonds, which are deemed to be in the nature of an advance.

C) Debentures/Bonds must be treated in the nature of an advance when:

- The debentures/bonds is issued as part of the proposal for project finance and the Tenure if the debenture us for a period of three years and above.

Or

- The debenture/bond is issued as part of the proposal for working capital finance and the tenure of the debenture/bond is less than a period of one year.

and

- The bank has a significant stake i.e., 10% or more in the issue.

and

- The issue is part of a Private Placement i.e., the borrower has approached the Bank/FI and not part of a public issue where the Bank/FI has subscribed in response to an invitation.

The debentures/bonds deemed to be in the nature of advance will be subject to the usual prudential norms applicable to advances.

3. The banks, which had already marked to market more than 75% of their SLR portfolio, will be given the option to re-classify their investments under this category up to the permissible level.

4. Profit on sale of investments in this category should be first taken to the profit & loss account and there after be appropriated to the 'Capital Reserve Account'. Loss on sale will be recognized in the Profit & Loss Account.

5. The banks will have the freedom to decide on the extent of holding under available for Sale and Held for trading categories. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position.

6. The investments classified under Held for Trading Category would be those from which the Bank expects to make a gain by the movement in the interest rates market rates. These securities are to be sold within 90 days. If the bank is notable to sell the security within 90 days due to exceptional circumstances such as tight liquidity conditions, or extreme volatility or market unidirectional the security should be shifted to the Available for Sale Category subject to items 12 and 13 below.

7. Profit or Loss on sale of investments in both the categories will be taken tot eh profit & loss account.

D) Shifting among Categories:

8. Banks may shift investment to /from Held to Maturity category with the approval Board of Directors once year. Such shifting will normally be allowed at the beginning of accounting year. No further shifting to /from this category will be allowed during the remaining part of that accounting year.

9. Banks may shift investments from Available for Sale category to Held for trading category with the approval of their Board of Directors/ALCO/Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the Bank/Head of the ALCO, but should be ratified by the Board of Directors/ALCO.

10. Shifting of investments from Held for Trading category to Available for Sale Category is generally not allowed. However, it will be permitted only under exceptional circumstances as mentioned at item 8 above, subject to depreciation if any, applicable on the date of transfer, with the approval of the Board of Directors / ALCO/Investment Committee.

11. Transfer of scrip from one category to another, under all circumstances, should be done at the acquisition cost/book value/market value on the date of transfer, whichever is the least, and the deprecation, if any, on such transfer should be fully provided for.

E) Valuation:

12. Banks should recognize any diminution, other than temporary, in the value of their investments in Subsidiaries/joint ventures which are included under Held to Maturity category and provide therefore. Such diminution should be determined and provided for each investment individually.
13. The individual scrip's in the Available for Sale category will be marked to market at the year-end or at more frequent intervals. While the net depreciation under each class. Referred to in item 1 above should be recognized and fully provided for as indicated in item 17 below. The net appreciation under each classification referred to in item 1 above should be ignored.

The book value of the individual securities would not under to any change after the revaluation.

[Note : Securities under this category shall be valued scrip-wise and depreciation/appreciation shall be aggregated for each classification referred to in item 1 above. N net depreciation, if any, shall be provided for. Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any on classification should not be reduced on account of net appreciation in any other classification.]

14. The provisions required to be created on account of depreciation in the Available for Sale category in any year should be debited to the Profit & Loss Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to statutory reserve) or the balance available in the Investment Fluctuation Reserve Account, whichever is less, shall be transferred from the Investment Fluctuation Reserve Account to the Profit & Loss Account. In the event provisions created on account of deprecation in the Available for Sale category are found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss Account and an equivalent amount (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess Provision) should be appropriated to the Investment Fluctuation Reserve Account to be utilized to meet the future depreciation requirement for investments in this category. The amounts debited to the Profit & Loss Account for provision and the amount credited to the Profit & Loss Ac for reversal of excess provision should be debited & credited respectively under the head "Expenditure-Provisions & Contingencies". The amounts appropriated from Profit & Loss Account and the amount transferred from the investment & Loss Account and the amount transferred from the Investment Fluctuation Reserve to the Profit & Loss Account should be shown as 'Below the Line' items after determining the profit for the year.

15. The individual scrip's in the Held for trading category will be revalued t monthly or at more frequent intervals and the net appreciation/depreciation under each classification referred to in item 1 above will be recognized in the income account. The book value of the individual scrip will change with the Revaluation.

F) General:

In respect of securities included in any of the three categories where interest/Principal is in arrears, the Banks should not reckon income on the securities and should also make appropriate provisions for the deprecation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

G) Market Value:

The 'Market Value' for the purpose of periodical valuation of the investments included in the Available for Sale and the Held for Trading categories would be the Market price of the scrip as available from the trades/quotes on the stock exchanges, SGL account transactions, price lit of Reserve Bank of India, prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivates Association of India (FIMMDA) periodically. In respect of unquoted securities, the procedure as detailed below should be adopted.

Unquoted SLR Securities:

Central Government Securities

- The Reserve Bank of India will not announce the YTTM rates for unquoted/Government Securities, as hitherto, for the purpose of valuation of investments by banks. The banks should value the unquoted Central Government Securities on the basis of prices/YTM rates put out by the PDAI/FIMMDA at periodical intervals.

- The 6 percent capital Indexed Bonds may be valued at "cost" as defined in circular DBOD. NO.BC.8/12.12/2001/ 97-98 dated January 22, 1998 and BC.1/12.02.001/2000-2001 dated August 16, 2000.

- Treasury bills should be valued at carrying cost.

State Government Securities

- State Government Securities will be valued applying the YTM method by marking it up 25 basis points above the yields of

the Central Government Securities of equivalent maturity put out by PDAI/FIMMDA periodically.

Other 'Approved Securities'

- Other approved securities will be valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalence Maturity put out by PDAI/FIMMDA Periodically.

- All debentures/bonds other than debentures/bonds which are in the nature of Advance should be valued on the YTM basis. Such debentures/bonds may be of different companies having different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government Securities as put out by PDAI/FIMMDA periodically.

  I. The rates used for the YTM for rated debentures/bonds should be at least 50 basis points above the rate applicable to a Government of India loan of equivalent maturity.

  II. The rate used for the YTM for unrated debentures/bonds should not be less than the rate applicable to rated debentures/bonds of equivalent maturity. The mark-up for the unrated debentures/bonds should appropriately reflect the credit risk borne by the Bank.

  III. Where interest/principal on the debentures/bonds is in arrears, the provisions should be made for the debentures as in the case of debentures/bonds treated as advances. The depreciation /provision requirement towards debentures where the interest is in arrears or principal is not paid as per due date, shall not be allowed to be set-off against appreciation against other debentures/bonds.

  Where the debentures/bonds is quoted and there have been transaction within 15 days prior to the valuation date, the value adopted should not be higher than the rate at which the transaction is recorded on the Stcok Exchange.

Preference Shares:

- The valuation of preference shares should be on YTM basis. The preference shares will be issued by companies with different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government Securities put out by the PDAI/FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the preference shares by the rating agencies subject to the following.

  I. The YTM rte should not be lower than the coupon rate/YTM for a GOI loan of equivalent maturity.

  II. The rte used for the YTM for unrated preference shares should not be less than the rate applicable to rated preference shares of equivalent maturity. The mark-up for the unrated preference shares should appropriate reflect the credit risk borne by the bank.

  III. Investments in preference shares as part of the project finance may be valued at par for a period of neither two years after commencement of production nor five years after subscription whichever is earlier.

  IV. Where investment in preference shares is as part of rehabilitation, the YTM Rte should not be lower than 1.5% above the coupon rte/YTM for GOI Loan of equivalent maturity.

  V. Where preference dividends are in arrears, no credit should be taken for accrued dividends and the value determined on YTM should be discounted by at least 15% of arrears are for one year, and more if arrears are for more than one year. The depreciation/provision requirement arrived at in the above manner in respect of non-performing shares where dividends are in arrears shall not be allowed to be se-off against appreciation on other Performing preference shares.

  VI. The preference share should not be valued above its redemption value.

VII. When a preference share has been traded on stock exchange within 15 days prior to the valuation date, the value should not be higher than the price at which the share was traded.

Equity Shares:

- Equity shares for which current quotations are not available or where the shares are not quoted on the stock exchanges, should be valued t break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's latest balance sheet (which should not be more than one year prior to the date of valuation). In case the latest balance sheet is not available the shares are to be valued at Rs.1 per company.

- Mutual Funds Units

  Investment in quoted Mutual Fund Units should be valued as per Stock exchange quotations. Investment in non-quoted Mutual Fund Units is to be valued on the basis of the latest re-purchase price declared by the Mutual Fund in respect of each particular Scheme. In case of funds with a lock-in period, where repurchase price/market quote is not available units could be valued at NAV. If NAV is not available then these could be valued at cost, till the end of the lock-in period. Wherever the re-purchase prince is not available the units could be valued at the NAV of the respective scheme.

- Commercial Papers

  Commercial papers should be valued at the carrying cost.

- Investments in RRBs

  Investments in RRBs are to be valued at carrying cost (i.e., book value) on consistent basis.

As per Reserve Bank of India circular dated 27/01/1998, banks are required to disclose certain important business parameters including financial ratios in the 'Notes on Accounts' to their balance sheet. Vide circular dated 10/02/1999, it has been decided that banks should disclose the following additional information in the 'Notes on Accounts' to the balance sheet from the account year dated March 31st 2000:

I. Maturity pattern of loans and advances
II. Maturity pattern of investment securities
III. Foreign currency assets and liabilities
IV. Movements in NPAs
V. Maturity pattern of deposits
VI. Maturity pattern of borrowings and
VII. Lending to Sensitive sectors as defined from time to time.

- **Impact of Provisioning on Banks:**

Banks are required to maintain a minimum Capital to Risk Asset Ratio (CRAR) of 9 percent from the year ending March 31st 2000. Narasimham Committee on Banking Sector Reforms had suggested increasing the CRAR to 10% by 2002.

The risk weights on calculation of CRAR

Sl. No:	Nature of Asset	Risk Weight %
1	Investments in Government Securities	2.5
2	Investments in other Approved Securities guaranteed by Central/State Government	2.5
3	Investments in other securities where payment of interest and repayment of principal is guaranteed by Central Government	2.5
4	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Government (In case of a default in interest/ principal banks should assign 100% risk weight on investments in securities guaranteed by the State Government and issued by defaulting entities)	2.5
5	Investments in other Approved securities where payment of interest and repayment of principal are not guaranteed by Central/State Government	20
6	Investment in Government Guaranteed Securities of Government undertakings which do not form part of the approved market borrowing programme	20
7	Balances in current account with other banks	20
8	Claims on banks and Public Financial Institutions (as per list attached)	20
9	Investments in bonds issued by other banks/Fis (as per list attached)	20
10	Investments in securities which are guaranteed by	20

	banks or PFIs (as per list attached) as to payment of interest and repayment of principal	
11	Investments in subordinated debt in the form of Tier II Capital Bonds issued by other bank/PFIs	100
12	All other investments	100

List of All-India Financial Institutions whose bonds/debentures would qualify for 20 per cent risk weight for Capital Adequacy Raito

01.Industrial Credit and Investment Corporation of India Ltd.,
02.Industrial Finance Corporation of India Ltd.,
03.Industrial Development bank of India,
04.Industrial Investment Bank of India Ltd.,
05.Tourism Finance Corporation of India Ltd.,
06.Risk Capital and Technology Finance Corporation Ltd.,
07.Technology Development and Information Company of India Ltd.,
08.Power Finance Corporation Ltd.,
09.National Housing Bank,
10.Small Industries Defaulter Bank of India,
11.Rural Electrification corporation Ltd,
12.Indian Railways Finance Corporation Ltd.,
13.National Bank for Agriculture and Rural Development,
14.Export Import Bank of India
15.Infrastructure Development Finance Company Ltd.,
16.HUDCO
17.IREDA (India Renewable Energy Development Agency)

Risk Weight for Government Guaranteed Advances:

Incases in which the guarantee has been invoked and the concerned State Government has remained in default as on March 31, 2000, a risk weight of 20 per cent on such advance should be assigned. In respect of State Governments who continue to be in default in respect of such invoked guarantees even after March 31, 2000, a risk weight of 100 per cent should be assigned.

Foreign Exchange/Gold opens positions

In terms of the Exchange Control Department AD (MA Series) circular No: 25 dated October 6, 1995, capital requirement for market risk on open foreign currency exposure has been prescribed at 5% of the position limit approved by the Reserve Bank. It has been decided that foreign exchange open position limit should carry 100% risk weight with effect from March 31, 1999.

In terms of Reserve Bank of India circular no: DBOD.IBS.BC.18/ 23.67.001/97-98 dated March 4, 1998, banks keeping open position in gold should also maintain Tier-I capital to the extent of 5% of the open position limit. It has been decided that open position limit in gold should also carry 100% risk weight with effect from March 31, 1999.

As per the existing practice, CRAR is calculated separately for open position limits in foreign exchange and gold and deducted from Tier-I Capital Risk Weights both in respect of foreign exchange and gold open position limits should be added to the other risk weighted assets for calculation of CRAR.

Risk Weight of Assts (Balance Sheet Items)

Sl.No.		Particulars	Risk Weight
I		Cash & Bank balance	0.00
	a)	Cash in hand (including foreign currency notes)	0.00
	b)	Balance with banks i) balance with RBI ii) balance with banks 1. Current a/c (In India and outside India) 2. Other a/cs c (In India and outside India)	 20.00 20.00
II		Money at call & short notices	20.00
III		Advances	
	a)	Government & other approved securities	2.50
	b)	Others (annexure –I)	100.00
	c)	Claim on public financial institutions	20.00
	d)	Indira Vikas Patras	2.50
	e)	Claims on PSUs guaranteed by Government	2.50
	f)	RIDF	20.00
IV		Advances	
	a)	Claims guaranteed by Government of India	2.50
	b)	Claims guaranteed by State Government	2.50
	c)	Claims on public sector undertakings of Government of India	2.50
	d)	Claims on public sector undertakings of State Government	2.50
	e)	Against NSC, LIC policies, IVP, KVP etc.	2.50
	f)	DICGC claims received	0.00
	g)	ECGC claims received	0.00
	h)	IRDP Subsidy Reserve Fund	0.00
	i)	Advances covered by ECGCs	50.00
	j)	Bills purchased under other Bank's LC	20.00

	k)	Others (See Annexure II)	100.00
V		Premises (net of depreciation provided)	100.00
VI		Other Fixed Assets (Net of depreciation provided)	100.00
VII		Assets given on lease (net of depreciation provided and net of provision for NPA)	100.00
VIII		Other Assets (including branch adjustments, non-banking asset etc) (See Annexure III) Int. receivable on PFI	100.00 20.00
		Int. receivable on Government Securities (incl. Appl. Money)	2.50
		Int. receivable on Government Guaranteed PSU banks	2.50
		Int. receivable on Bank Deposits	20.00
		Int. receivable on RIDF	20.00
		Int. receivable on IVP	2.50
		Application money for Bonds guaranteed by Government.	2.50
		Application money for Bonds of PFIs	20.00

Weighted non-funded exposures, off balance sheet items:

Sl.No.	Nature of item	Conversion factor %	Risk Weight
1	Guarantees issued a) HDFC on behalf of staff members b) Against counter guarantee of other Banks Financial Guarantees c) Others d) DPGs	 50 100 20 100	 0 100 100 100
2	Bills co-accepted	0	0
3	Letters of Credit	20	100
4	Forward exchange contracts a) of 14 days or less b) 14 days to 1 year - Others - banks	 2 2 2	 0 100 20
5	Underwriting commitments	0	0
6	Partly paid investment	100	100

GUIDELINES FOR RECOVERY OF DUES RELATING TO NON PERFORMING ASSETS (NPAs) OF PUBLIC SECTOR BANKS:

Reserve Bank of India vide circular no>BP.BC.11/21.01.040/1999-2000 dated 27/07/2000, has issued the following guidelines for recovery of dues relating to NPA of Public Sector Banks.

1. Reference is invited to circular DBOD.BP.BC.57/21.01.040/99 dated May 29, 1999, setting out the guidelines for constitution of settlement advisory committees (SACs) for compromise settlements of chronic NPAs of small sector.

2. A review of compromise settlements of NPAs through settlement advisory committee (SACs) made by us has revealed that the progress of recovery of NPAs through this mechanism has not been encouraging. The recovery position in respect of categories of borrowers other than small sector has also not been satisfactory. Banks have represented to us that on account of the relative inflexibility of the parameters given in the aforesaid guidelines, much progress could not be made in the recovery of NPAs. While banks should take effective measures to strengthen the credit appraisal and post-credit monitoring to arrest the incidence of fresh NPAs, a more realistic approach is needed to reduce the stock of existing and chronic NPAs in all categories. It has therefore, been decided to modify the guidelines, which will provide a simplified, non-discretionary and non-discriminatory mechanism for recovery of the stock of NPAs. Al public sector banks should uniformly implement these guidelines, so that maximum realization of dues is achieved from the stock of NPAs within the stipulated time.

3. The revised guidelines will cover NPAs relating to all sectors including the small sector. The guidelines will not, however, cover cases of willful default, fraud and malfeasance. The banks should identify cases of willful default, fraud and malfeasance and initiate prompt action against them. Accordingly, in modification of guidelines set out in our circular of 27th May, 199, revised guidelines for recovery of dues relating to NPAs of public sector banks in all sector are given below:

(A) Guidelines for recovery of NPAs upto Rs.5.00 crores

(i) Coverage

a) The revised guidelines will cover all NPAs in all sectors irrespective of the nature of business, which have become doubtful or loss as on 31st March, 1997 with outstanding balance of Rs.5.00 crore and below on the cut off date.

b) The guidelines will also cover NPAs classified as sub-standard as on 31st March 1997, which have subsequently become doubtful or loss category.

c) These guidelines will also cover cases pending before courts/DRTs/BIFR, subject to consent decree being obtained from the courts/DRTs/BIFR.

d) Cases of willful default, fraud and malfeasance will not be covered.

e) The revised guidelines will remain operative only upto 31st March, 2001.

(ii) Settlement Formula-Amount and off date

a) NPAs classified as doubtful or loss as on 31st March, 1997
The minimum amount that should be recovered under the revised guidelines in respect of compromise settlement of NPAs classified as doubtful or loss as on 31st March, 1997 would be 100% of the outstanding balance in the account as on the date of transfer to the protested bills account outstanding as on the date on which the account was categorized as doubtful NPAs, whichever happened earlier, as the case may be classified as sub-stand.

b) NPAs classified as Sub-Standard as on 31st March, 1997 which became doubtful or loss subsequently
The minimum amount that should be recovered in respect of NPAs classified as sub-standard as on 31st March 1997, which became doubtful or loss subsequently would be 100% of the outstanding balance in the account as on the date of transfer to the protested bills account or the amount outstanding as on the date on which the account was categorized as doubtful NPAs, whichever happened earlier, as thecae may be, plus interest at existing prime lending rate from 1st April, 1997 till the date of final payment.

(iii) Payment

The amount of settlement arrived at in both the above cases, should preferably be paid in one lump sum. In cases where the borrowers are unable to pay the entire amount in one lump sum, at least 25% of the amount of settlement should be paid upfront and the balance amount of 75% should be recovered in installment within a period of one year together with interest at the existing prime lending rate from the date of settlement up to the date of final payment.

(iv) Sanctioning Authority

The decision on the compromise settlement and consequent sanction of waiver or remission or write-off should be taken by the competent authority under the delegated powers.

(v) Non-discretionary Treatment

The banks should follow the above guidelines for compromise settlement of all NPAs covered under the revised scheme, without discrimination and a monthly report on the progress and details of settlements should be submitted by the concerned authority to the next higher authority and their central office,. Banks should give notice by 31st August, 2000 to the eligible defaulting borrowers to avail of the opportunity for one time settlement of their outstanding dues in terms of these guidelines. Adequate publicity through various means to these guidelines must be ensured.

(vi) Reporting to the Board

The banks should submit a report on the progress in the re of NPAs under the revised guidelines every quarter to the board of directors. A copy of the quarterly progress report should also be sent to us.

(B) Guidelines for recovery of NPAs over Rs. 5.00 crore

(i) CMDs should personally supervise the NPAs of Rs.5.00 crore and above on case-to-case basis. A list of such NPAs should be prepared and all cases reviewed by CMD personally and the course of action decided in terms of rehabilitation/restructuring, one time settlement or filing of suits, by 31st August 2000, the matter should be placed before the board of directors, finalizing the course of action by 30th September, 2000 in each such case.

(ii) The board of directors may evolve policy guideline regarding one time settlement of NPAs over Rs.5.00 crore covering the non computation formula, realizable amount, cut off date and payment conditions with reference to factors of security and disposability, etc. as part of its loan recovery policy including setting up of settlement advisory committee, staff accountability and other relevant aspects and decide individual cases in accordance with such policy. A copy of such policy should also be sent to us.

(iii) Wherever a suit is required to be filed against the defaulters who have not come up for one time settlement,

or where restructuring is not feasible, suits must be filed in all such case by 31st October, 2000. Banks should follow up suit filed cases vigorously and effectively in the courts to enable DRTs to decided the cases within 6 months as laid down in the Debt Recovery Tribunal Act and realization of dues completed at the earliest a quarterly report in regard to outstanding of above Rs.5.00 crore should also be sent to us.

4. Deviation only be board of directors

Any deviation from the above settlement guidelines for any borrower should be made only be the Board of directors.

Perceptions on Management of NPAs

With view to ascertaining the opinion of bankers and officials connected with the connected with the banking system, on the implications of NPAs of banks on their Balance Sheets, a survey was conducted by means of a questionnaire. For the purpose of survey, the questionnaire was issued to the officials of banks and the Reserve Bank of India, including Chairmen and Managing Directors, Nominee Directors and senior and middle level Executives of both public and private sector banks, and Ex-Executive Directors, Chief General Managers, General Managers, Deputy General Managers and other senior and middle level officers of the Reserve Bank of India. The Officers chosen for the study have long experience and good exposure in the management of credit in different capacities, in different institutions and in different regions. Opinions from officials of the Reserve Bank of India were sought from the angle of regulator and supervisor of bank stock understand more about the problem of Non-Performing Advances. The data for this Chapter thus, consist of the views expressed by the 154 Executives of banks and the Reserve Bank of India, chosen for the study. The views were given in their personal and individual capacity and need not be taken as views reflecting those of their institutions.

The questionnaire issued for the survey consisted of broadly six areas, viz.,

1. the causes leading to NPAs
2. general opinion on impact of NPAs,
3. implications of NPAs on banks' books,
4. specific suggestions to contain NPAs,
5. views on the attitude of borrowers with regard to repayment of loans, and

6. general comments and suggestions on NPAs.

The Study covers three categories of official's viz., those belonging to Top/Senior Management, Middle management and Junior Management. Top/Senior Management generally involves in framing policies and overseeing implementation of policies. Middle Management generally guides and supervises execution of policies at operational level. The Junior Management carries out the instructions of Top/Middle Management keeping the objectives of the Management and at the same time keeping in view of interests of both the banks and the customers. In fact, as far as NPAs are concerned, the Junior Management being at the operational level gets a better and instant feel of the symptoms of NPAs and can do and undo many things both for the befit of the Management and the customers. A strong Junior Management can be an effective asset in containing NPAs. The Survey has also given weight age for the long years of experience of the officers of the respective Management cadres and the results have been sifted accordingly. Experience has been put under four categories, i.e.,

1. those with experience of less than 10 years,
2. those with experience of less than 20 years
3. those with experience of 20 years to 30 years and
4. those with experience of more than 30 years.

Frequency distribution of the respondents as per their position in Management in given in Table 1.

Table 1

Position-wise Distribution of Executives

Respondents Position	Frequency	Per cent
Top / Senior Management	30	17.76
Middle Management	49	28.99
Junior Management	75	44.38
Professionals	15	8.87
	169	100.00

The Executives representing Middle and Top/Senior Management account for 51.3 per cent of the total. Since officials of the Top/Senior Management generally move from one bank to another and one region to another region, their opinions carry more weight because of their varied and wider practical experience.

Frequency distribution of the Executives as per their experience in Bank Management is given in Table 2.

Table 2

Experience-wise Distribution of Bank Executives

Experience in years		Frequency	Per cent
Less than 10 years	(1)	14	9.1
10-20 years	(2)	44	28.6
20-30 years	(3)	58	37.6
Above 30 years	(4)	38	24.7
Total		154	100

It will be seen from table 2 that 90,0 per cent of the Executives have put in more than 10 years of service and as such their opinions on Management of NPAs should reflect a realistic and reliable picture.

The institution-wise Frequency distribution of Executives is furnished in Table 3.

Table 3

Institution-wise Distribution of Executives

Bank Groups	Frequency	Per cent
Reserve Bank of India	99	58.58
Public Sector Banks	38	22.49
Private Sector Bank	17	10.06
Professionals	15	8.87
	169	100.00

It could be seen from Table 3 that the officials of the Reserve Bank constitute a larger percentage of the sample of Executives considered for the Study. The experience of officials associated with Regulatory and Supervisory functions of the Reserve Bank of India and their exposure to overseeing credit administration and inspection of various banks and financial institutions spread over the entire country is highly valuable and as such their comments and suggestions would carry conviction. Besides, their experience as a global touch.

Table 4

Reason for NPAs.

Major Reasons	Mean Scores	Rank
Diversion of Funds	5.26	1
Willful Default	5.13	2

Lack of Supervision and follow up	4.59	3
Deficiency in Credit Appraisal Standards	4.56	4
Lack of Legal Support	3.81	5
Policitical Interference	3.13	6
Higher Rate of Interest	1.77	7

It will be observed from Table 4 that diversion of funds is the major cause for NPAs followed by willful default, lack of supervision an follow-up and deficiency in credit appraisal standards in that order. Lack of legal support, although generally perceived as a major stumbling block in the recovery of loans, has been ranked comparatively low at number five among the reasons for Non-Performing Loans. Like-wise political interference and high rate of interest have been ranked very low as reasons of NPAs contrary to the general belief.

Bank category-wise analysis of reasons for NPAs is given in Table 5.

Table 5

Bank Category-wise Classification of Reasons for NPAs.

Major Reasons	Bank Groups (Mean Scores)			Total
	RBI	PSBs	Private Banks	
Political Interference	3.21 (6)	3.27 (6)	2.33 (6)	3.13 (6)
Willful Default	4.90 (3)	5.56 (1)	5.60 (2)	5.13 (2)
Diversion of Funds	5.18 (1)	5.24 (2)	5.80 (1)	5.26 (1)
Lack of Legal Support	3.81 (5)	4.00 (4)	3.33 (5)	3.81 (5)
Deficiency in Credit Appraisal Standards	4.96 (2)	3.70 (5)	4.00 (4)	4.56 (4)
Lack of Supervision and Follow up	4.53 (4)	4.79 (3)	4.56 (3)	4.59 (3)
Higher Rate of Interest	1.67 (7)	1.73 (7)	2.40 (7)	1.77 (7)

Note: Figures in brackets indicate ranks.

While RBI and Private Sector Bank groups identified diversion of funds as major contributing factor for NPAs., Public Sector Banks have identified willful as a major factor. In fact, willful default and diversion of funds can be viewed together as they are mutually the cause and effect for growing NPAs. This analysis confirms the results of Reserve Bank of

India study on NPAs, published in its July 10999 Bulletin.[29] Deficiency in the credit appraisal standards ranks high at two as per the officials of the Reserve Bank of India, whereas, it is ranked five and four by the officials of Public Sector Banks and Private Sector Banks, respectively. Lack of legal support, political interference and high rate of interest as causes of NPAs are ranked relatively low by officials of all bank groups covered in the survey. Thus blaming the legal system for growing NPAs is not a prominent cause contrary to general belief.

The F-test through analysis of variance indicates that deficiency in the credit appraisal standards, higher rate of interest and willful default is significant. While deficiency in the credit appraisal standards has the f-test value with a significance of .002, higher rate of interest and willful default have the F-test values with a significant of .087 and .0-52 respectively.

The major cause as per the opinion of the management categories is given in

Table 6.

Management Cadre-wise Distribution of Causes for NPAs

Major Reasons	Management Cadre Mean Scores			Total Sample
	Top	Middle	Junior	
Political Interference	3.11 (6)	2.91 (6)	3.2 (6)	3.13 (6)
Willful Default	4.89 (4)	4.84 (3)	3.28 (5)	5.13 (2)
Diversion of Funds	5.07 (2)	4.93 (2)	5.54 (1)	5.26 (1)
Lack of Legal Support	3.46 (5)	3.82 (4)	3.93 (4)	3.81 (5)
Deficiency in Credit Appraisal Standards	5.00 (3)	4.98 (1)	4.12 (3)	4.56 (4)
Lack of Supervision and Follow up	5.22 (1)	4.80 (4)	4.20 (2)	4.59 (3)
Higher Rate of Interest	1.56 (7)	1.77 (7)	1.84 (7)	1.77 (7)

Note: Figures in brackets indicate ranks.

It is interesting to observe from Table 6 that while the Top Management has identified lack of supervision and follow-up as a major cause for

[29] Some Aspects Relating to NPAs in Commercial Banks, *Reserve Bank of India Bulleting, July 1999, p.913.*

NPAs, Junior Management has identified diversion of funds as a major cause. A study by Reserve Bank of India on the Non-Performing Advances of Public Sector Banks also confirms diversion of funds as a major for NPAs.[30]

The Middle Management has given deficiency in credit appraisal standards as a major cause for NPAs. The opinions vary since on such contentious issues, the protective cadre consciousness and tendency to put the blame on someone else as a defense mechanism and reaction to the apprehension of fixing of accountability cannot rule out.

Table 7

F-test Results in Respect of Causes as per Management Cadre

Causes	F Value	Prob. Value	Remarks
Political Interference	0.530	0.590	Not Significant
Willful Default	2.240	0.110	Significant
Diversion of Funds	2.275	0.066	Significant
Lack of Legal Support	0.608	0.546	Not Significant
Deficiency in Credit Appraisal Standards	3.852	0.024	Significant
Lack of Supervision and Follow up	4.968	0.008	Significant
Higher Rate of Interest	0.502	0.606	Not Significant

The F-test done through analysis of variance has indicated significance in respect of deficiency in credit appraisal standards, lack of supervision and follow-up and diversion of funds and willful default.

Break-up of reasons for NPAs on experience basis is given in Table 7.

Willful default has been identified as a major cause for NPAs, as per the experience of the management in all categories. Management having more than 30 years of experience has found diversion of funds and willful default as the most important contributing factors for NPAs, which is also true as per the opinion given by Bank Groups and different Management Groups. The F-test has not indicated any item having significant difference among the different Experience Groups.

Ranking of opinion on support system for the recovery of NPAs for the banking system, as per the survey results are furnished in Table 8 and 9, respectively.

[30] Some Aspects Relating to NPAs in Commercial Banks, *Reserve Bank of India Bulleting, July 1999, p.913.*

Table 8

Reasons for NPAs as per Length of Experience of Executives

Reasons	Experience of Executives (Mean Scores)			
	Less than 10 yrs	10 to 20 years	20 to 30 years	More than 30 years
Political Interference	3.57 (6)	3.05 (6)	3.11 (5)	3.06 (6)
Wilful Default	5.00 (2)	5.10 (2)	5.05 (1)	5.35 (2)
Diversion of Funds	4.86 (3)	5.44 (1)	5.05 (1)	5.56 (1)
Lack of Legal Support	3.62 (5)	4.08 (5)	3.59 (4)	3.94 (5)
Deficiency in Credit Appraisal Standards	5.14 (1)	4.45 (4)	4.60 (3)	4.38 (3)
Lack of Supervision and Follow up	4.29 (4)	4.66 (3)	4.89 (2)	4.15 (4)
Higher Rate of Interest	1.71 (7)	1.59 (7)	1.83 (7)	1.88 (7)

Note: Figures in brackets indicate ranks.

Ranking of opinions on the support system given by the respondents is furnished in Table 9.

Table 9

Ranking of Opinion on Support System

Opinion	Mean Scores	Rank
Representative bodies like FICCI, CCI, CII< FIEO, etc. do not support banks in the recovery of dues	3.22	1
Banks do not have effective market intelligence System to know more about the borrowers	3.12	2
Banks have no system of exchange of information About borrower customers	2.97	3
Inadequate staff to manage loan portfolio	2.59	4
Interest rates are not fixed according to borrowers Repaying capacity	2.32	5
Banks do not pay adequate attention to borrower Customers	2.14	6

It will be observed from Table 9 that opinion in respect of lack of support received from representative chambers like, Federation of Indian Chamber of Commerce and Industry (FICCI), Chamber of Commerce and Industry (CCI), Confederation of Indian Industry (CII) and Federation of Indian Exporters organization (FIEO), etc., in recovering the banks' dues from their members ranked No.1 closely followed by lack of intelligence system in banking in tracking and tackling the NPAs early. The mean score has ranked after 3 in respect of opinion with regard to bank's inadequate arrangements to have market intelligence to know more about the borrowers. The opinion results also strongly indicate that there is no system of exchange of information among banks about their borrowers, inadequacy of staff to manage loan portfolio, general aversion to lending among banks because of NPAs.

The bank executives are asked to indicate their views on the implications of NPAs on their banking operations. Table 10 provides the details:

Table 10

Ranking of Opinion on Implications of NPAs on Banking System

Opinion on implications	Mean Scores	Rank
Banks prefer investment in Government securities to Advances because of NPAs	3.11	1
Banks have a general aversion to lending because of NPAs	2.94	2
NPAs affect only banks and other stake holder, other Than defaulting borrowers	2.66	3
Banks raise subordinated debt at high cost to supplement Tier II Capital and to meet Capital Adequacy Norms	2.53	4
Banks are unable to bring down interest rate on Account of NPAs	2.53	4
Present Capital Adequacy reduces/minimizes the Risk of NPAs	2.27	5
Interest charged to borrowers far exceed the declared PLR	2.18	6
Overall cost to borrowers is very high resulting in NPAs	2.10	7

Opinion on implications indicate that there is a marked preference for banks to investment in Government securities because of growing NPAs and that NPAs affect only banks and other stake holders, other than defaulting borrowers. There is also comparatively strong opinion with regard to banks' charging interest far in excess of PLR, inability to bring down the rant of interest to borrowers, levy of excessive overall cost from

borrowers on account of NPAs and need to raise subordinate debt at high cost to supplement their Tier II Capital and to meet Capital Adequacy Norms.

Six major items have been identified where NPAs can have impact on banks' books. The impact of NPAs on banks' books, as revealed by the Survey is furnished in Table 11.

Table 11

Impact of NPAs on Banks' Books

Impact	Mean Scores	Rank
Increasing Provisions	5.19	1
Erosion of Profit	5.06	2
Declining Reserves and Surplus	3.68	3
Increasing Intermediation Cost	2.89	4
Increasing Spread	2.68	5
Increasing Market Borrowings	1.78	6

The mean score is very high in respect of impact of NPAs on increasing provisions and erosion of profit. The impact is fairly high resulting in the decline of reserves and surpluses and increase of intermediation cost.

The ranking on the impact of NPAs on banks' books, according to bank groups is furnished in Table 12.

Erosion of Profit, increasing provisions and declining reserves and surpluses rank high in that order on the impact of NPAs on banks;' books. Perception of all bank groups is more or less similar on ranking. However, the concern of Reserve Bank of India on the increasing provisions and the concern of PSBs on erosion of profit are very much revealing in the ranking. Analysis of variance test shows a significant difference in bank groups in respect of erosion of profit (F-value: 5.283)

Table 12

Impact of NPAs on Banks' Books – Bank Group-wise

Impact	Bank Groups (Mean Scores)			Total
	RBI	PSBs	Private Banks	
Erosion of Profit	4.68 (2)	5.51 (1)	5.13 (1)	5.06 (2)

Increasing Spread	2.82 (2)	2.41 (5)	2.64 (5)	2.68 (5)
Increasing Intermediation Cost	2.88 (4)	2.68 (4)	3.44 (4)	2.89 (4)
Increasing Provisions	5.27 (1)	5.05 (2)	5.00 (2)	5.19 (1)
Declining Reserves and Surpluses	3.72 (3)	3.70 (3)	3.38 (3)	3.68 (3)
Increasing Market Borrowings	1.87 (6)	1.65 (6)	1.62 (6)	1.78 (6)

Note: Figures in brackets indicate ranks.

The ranking given on the impact of NPAs on banks' books by difference categories of management is given in Table 13.

Table 13

Management Cadre-wise Classification of Impact of NPAs.

Impact	Management (Mean Scores)			Total
	Top	Middle	Junior	
Erosion of Profit	5.00 (2)	4.85 (2)	5.21 (1)	5.06 (2)
Increasing Spread	2.78 (5)	2.78 (5)	2.58 (5)	2.68 (5)
Increasing Intermediation Cost	3.33 (4)	2.91 (4)	2.71 (4)	2.89 (4)
Increasing Provisions	5.21 (1)	5.28 (1)	5.12 (2)	5.19 (1)
Declining Reserves and Surpluses	3.41 (3)	3.74 (3)	3.74 (3)	3.68 (3)
Increasing Market Borrowings	1.62 (6)	1.70 (6)	1.90 (6)	1.78 (6)

Note: Figures in brackets indicate ranks.

Increasing provisions and erosion of profit rank very high as per the management's perception on the impact of NPAs on banks' books as revealed in Table 12. The F-test is significant only in respect of increasing intermediation cost (F-value 2.784).

From the experience point of view, the impact of NPAs as revealed in the survey is indicated in Table 14.

Table 14

Experience-wise Classification (Length of Experience of Management Cadre) of Impact of NPAs

Impacts	Mean as per experience (Mean Scores)				Total
	Less than 10 yrs	10 to 20 years	20 to 30 years	More than 30 years	
Erosion of Profit	4.93 (2)	5.10 (1)	5.04 (2)	5.11 (2)	5.06 (2)
Increasing Spread	2.09 (5)	2.84 (4)	2.80 (5)	2.53 (5)	2.68 (5)
Increasing Intermediation Cost	2.54 (4)	2.83 (5)	2.98 (4)	2.94 (4)	2.89 (4)
Increasing Provisions	5.29 (1)	5.00 (2)	5.23 (1)	5.31 (1)	5.19 (1)
Declining Reserves and Surpluses	4.29 (3)	3.74 (3)	3.58 (3)	3.53 (3)	3.68 (3)
Increasing Market Borrowings	2.08 (6)	1.98 (6)	1.58 (6)	1.75 (6)	1.78 (6)

Note: Figures in brackets indicate ranks.

It will be observed from Table 14 that the impact of NPAs is felt more on increasing provisions, erosion of profit and declining reserves and surpluses as per the ranking given from the experience of the different management cadres. The highest ranking given to increasing provisions has come from the maximum experience group. The impact of NPAs not resulting in increasing market borrowings has been uniformly ranked 6 by all the groups.

The F-test does not indicate any significance for any item in Table 14.

In respect of specific suggestions to contain NPAs of banks, the ranking given as per the survey results is given in Table 15.

Table 15

Suggestions to Contain NPAs

Specific Suggestions	Mean	Rank
Borrowers to be made accountable/responsible	3.30	1
Maintaining continuous rapport with the borrowers	2.99	2
Corporate governance in corporate bodies	2.98	3
Auditors, accountants, regulators and Representative bodies should be involved	2.76	4

The ranking is high in respect of making borrowers more accountable/ responsible in containing the NPAs. The survey also strongly suggests to maintain continuous rapport with the borrowers and to have effective corporate governance in corporate bodies to contain the growing problem of NPAs. This is possible only if banks keep a very close watch on their standard advances. The solution offered through this study is from this angle and will prove to be beneficial in the long run and over a period, both banks and borrowers will become responsible in the conduct of accounts.

The perception of management on the attitude of borrowers, as revealed by the survey is furnished in Table 16.

Table 16

Assessment of Type of Borrowers

Category	(As percentage to total no. of borrowers)		
	Minimum	Maximum	Mean
Good borrowers willing to repay	10	95	50.12
Good borrowers not willing to repay	1	60	18.86
Bad performers but still willing to repay	1	70	15.36
Bad performers not willing to repay	1	95	21.81

As revealed in Table 16 good borrowers not willing to repay and bad performers not willing to repay which broadly constitute the willful defaulters category, are sizable. These categories of borrowers arise out of standard advances and it should not be difficult for banks to kept a track of these borrowers. The suggestion given in Chapter 5 is aimed at these specific categories.

The response by the management groups to the general comments/ suggestions on management of NPAs is furnished in Table 17.

Table 17

Response of the Executives and their Comments / Suggestions

Nature of Comments / Suggestions	No. of Officers who have offered comments/suggestions			Total
	Top/Senior Management	Middle Management	Junior Management	
Improve the Appraisal System	21	27	33	81

Continuous Monitoring And Follow up	19	31	26	76
Improve Legal System	23	36	37	96
Improve Exchange of Information	14	18	21	53
Improve Market Intelligence Information	11	21	17	49
Improve Market Intelligence System	17	23	27	67
Avoid Political Interference	18	29	15	62
Introduce Incentive/ Reward System to staff	13	11	16	40

It will be observed that opinion generally is in favor of effecting improvement in the systems of appraisal, legal, exchange of information and market intelligence, to contain the future formation of Non-Performing Advances. In fact the model suggested here is on the similar lines with emphasis on keeping a close watch on standard advances which will ensure satisfactory conduct of accounts by the borrowers and close monitoring of the accounts by the lenders, taking into consideration by and large all the suggestions brought out in the survey. Staff lapses, if any, in the appraisal standards will be revealed in the conduct of accounts and it should possible to fix accountability thereon.

The survey has helped to gather some general comments and suggestions form officials of different bank groups, based on their practical experience and in-depth knowledge on NPAs menace and dealings with various types of borrowers.

CHAPTER – V

RECOVERY OF NPAs

CHAPTER V

RECOVERY OF NON PERFORMING ASSETS

Recovery of money through the attachment and sale of immovable properties the most commonly employed method of executing the decree. The reason being that value of the property appreciates with time as against moveable properties, discussed in the subsequent chapters, where the value of the property depreciates with the passage to time. This means the recovery is also riddled with most grave and complicated legal issues. In this chapter, we shall deal with the manner of attachment of immovable property and the sale of the same towards the satisfaction of the decree. Along with this we shall also discuss the objections faced by the decree holder, before he could enjoy the fruits of the decree passed in his favor.

Measure introduced all these years to contain the problem loans, have no doubt helped to create sufficient awareness about the seriousness of the problem among the lenders, but have hardly made any impact of the on the borrowers to be more responsible and accountable on their part and extending co-operation to banks through time repayment. While genuine difficulties of the borrowers to repay the dues to banks because of circumstances beyond their control are understandable, misuse of the funds by the borrowers and taking shelter under the weakness of the legal system in order to avoid/delay payment of banks dues, is deliberate.

Banks have evolved policies for recoveries and write off bad loans by incorporating compromise and negotiated settlements with the approval of their Boards, particularly for old and unresolved cases falling under the category of Non Performing Advances. Banks have also set-up independent Settlement Advisory Committees headed by retired judges of the High Courts, to scrutinize and recommend compromise proposal. Other measures introduced, inter alia, include on time non-discretionary and non-discriminatory settlement of Non Performing Advances of Small Scale Sector (the scheme was operative up to September 2001), special guidelines for recovery of the stock of Non Performing Advances of Rs. 5 crores and less as on 31st March 1997 (Guidelines valid up to June 30, 2001) and One-Time Settlement Scheme covering advances of Rs. 25,000 and below.

Further, measures have been considered for faster legal process to enable the banks to bring down the level of Non Performing Advances. These broadly relate to:

1. Setting up of Lok Adalat Instructions to help banks settle dispute involving accounts in Doubtful and Loss categories with outstanding balance of Rs. 5 lakh for Compromise Settlements.

2. Empowering Debt Recovery Tribunals to organize Lok Adalats to decide on cases of Non Performing Advances of Rs. 10 lakh and above.

3. Strengthening the functioning of Debt Recovery Tribunals through amendment of the Act on Recovery of Debts due to banks and financial institutions in March 2000 and grant of more powers to Tribunals to:
    i. Attach defendant's property/ assets before judgment.
    ii. Penalize for disobedience of Tribunal's order or for breach of any terms of the order, and
    iii. To appoint receiver with powers or realization, management, protection and preservation of property.

These measures are expected to provide necessary teeth to the Debt Recovery Tribunals and speed up the recovery Non Performing Advances in times to come. In all 22 Tribunals and Five Appellate Tribunals have been set-up and they have recovered a sum of Rs. 1,864.30 crore out of NPAs of Rs. 6,264.71 crore referred to the Tribunals since their inception.

➢ **Recall of Advances:**

Other administrative measures to contain the menace of Non Performing Advances include:

1. Circulation of details of willful default of borrowers of bank and financial institutions. To serve as a Caution List while considering cases of new or additional credit limits from defaulting borrowering units and also from the Director/proprietor/Partners of these entities.

2. Publication of list of borrower (with outstanding aggregating Rs.1 cores and above) against whom suits have been filed by banks and financial institutions for recovery of their loans, as on 31st March every year.

3. Introduction of Corporate Debt Restructuring to minimize slippage of Standard Advances to NPAs.

➤ Difficulties in Legal Procedure:

However, these measures have not contributed to any perceptible recoveries from the defaulting entities although they have served as negative basket of steps shutting off fresh loans to these defaulters. Measures are also being contemplated that in all cases of willful default of Rs. 1 core and above to tile criminal cases.

Thus, it is felt that chronic ailments require aggressive and drastic remedies.

The pernicious nature of the NPA crisis can be gauged from the following cross-section of observations.

"if someone takes what is not his own, he must give it back or go to prison".

...Market aphorism

Steal a few lakhs and you are a criminal. Steal a few hundred crores and you become in industrialist, rubbing shoulders with the high and mighty of the land. Or so it would seem from then Finance Minister Jaswant Singh's statement in the Rajya Sabha that "Non-Performing Assets of Rs. 83,000 crore is loot and not debt"

There are sick companies; sick banks and unpaid workers, but there are hardly any sick promoters. There lies the heart of the matter (The Omkar Goswami Report on Industrial Sickness and Corporate Restructuring)

➤ Need for Law Reforms:

The legal system in India has been cited as one of the major reasons for ever growing problem of NPAs in banks. General opinion on the subject is that present legal system favours the borrower and not the lender. It is perceived that this weakness is fully exploited by the borrowers. The Committee on Financial System (1991) and the committee of Banking Sector Reforms (1998), have made strong observation on the need to strengthen the legal infrastructure, to improve the recovery culture of commercial banks. The Committee on Banking Sector Reforms has also recommended setting up an Asset Reconstruction Company with appropriate legal backing to take over the assets of defaulting borrowers. Acts related to banking and sale of securities have been recommended to be suitably amended to enable banks to ensure speedy recoveries. The problem arising out of the legal infrastructure can be gauged from the fact that there are about 23 or more Acts operating simultaneously making it convenient for the borrower to find escape routes. The Acts required to be amended are:

01. Indian Contract Act, 1872
02. Negotiable Instrument Act, 1881
03. Transfer of Properties Act, 1882
04. Bankers Book Evidence Act, 1891
05. Indian Stamp Act, 1899
06. Co-operatives Societies Act, 1904
07. Code of Civil Procedure, 1908
08. Sale of Goods Act, 1930
09. Indian Partnership Act, 1932
10. Reserve Bank of India Act, 1934
11. Banking Regulation Act, 1949
12. State Financial Co-operation Act, 1951
13. Companies Act, 1956
14. Regulation Act, 1956
15. Securities Contract (Regulation) Act, 1969
16. Income Tax Act, 1961
17. Monopolies and Restrictive Trade Practices Act, 1969
18. Interest Tax Act, 1972
19. Public Financial Institutions (Obligations as to Fidelity and Secrecy) Act, 1972
20. Sick Industrial Companies Act, 1985
21. Securities and Exchange Board of Indian Act, 1992
22. Debt Recovery Tribunal Act, 1993
23. Insurance Regulatory and Development Act, 1999

It has been decided to do away with Sick Industrial Companies Act and referring of cases to Board for Financial and Industrial Reconstruction (BIFR) which impede the process of recoveries of banks dues.

Institutions like Confederation of India Industry (CII) Federation of Indian Chamber of Commerce and Industry (FICCI), Chamber of Commerce and Industry (CCI), Indian Merchant Chamber (IMC), Federation of Indian Exporters Organization (FIEO) have generally taken a view supportive of the interests of their respective member organizations, in the matter of NPAs, which have not appreciated the problem from the angle of the lenders viz. safely and return of banks funds which are mobilized from public.

Setting up of DRTs to ensure speedy recovery of banks dues have yielded only small benefits to banks so far and banks continue to suffer from the problem of Non Performing Advances. The saying that 'Justice delayed is Justice denied', is providing true in the banking scenario also, as several cases involving crores of rupees are pending disposal in various courts for a number of years. On an average it takes more than a decade to get a final verdict in a law suit here, as against six to eight months in USA.

In order to improve the legal infrastructure and help the banking system to recover its dues without the intervention of court, the Government set-up a committee under the chairmanship of Shri.T.R.Andhyarjina

Expert Committee Recommendations Relating to NPAs

Commenting on the directed lending programme, the Committee on Financial System (1991) observed that, unfortunately, over the years, the nexus between credit expansion and productivity has been weakened and is reflected in the blurring of the distinction between the concepts of credit need and credit worthiness. Collateral requirements have been eased and this combined with inadequate appraisal of credit applications in terms of productive use of credit and insufficient post-credit supervision, has affected recovery of dues and increased loan delinquencies. The disturbing growth in over dues is a consequence of the measure of laxity and departure from the principles of sound banking.

The intended socially oriented credits like IRDP have, in the process, degenerated into irresponsible lending. Loan waivers have added an additional element of politicization of banking, apart from the grave damage tot the concept of credit discipline by encouraging defaults. The political element which condones over dues should also have paid regard to the social obligation which banks owe to their depositors to invest their funds with due prudence.

In a scenario of prevailing deterioration in credit accounts in respect of sick industries, banks had to conform to general and sometimes specific instructions from Governments (both Central and States) to continue extending credit to sick industrial units often against their better commercial judgment. Banks also had problems arising from the 'advice' received from BIFR and directions from Courts, to extend credit to sick units. These are regarded as a different form of directed credit. There is, therefore, urgent need to address the issue of infected loan portfolio in the various directed credit sectors.

The Tarapore Committee on Capital Market Convertibility felt that Non-Performing Assets (NPAs) of Public Sector Banks, estimated at 13.7 per cent of the total advances as at the end of March 1997, were very high. Quite clearly, the load of such a level of NPAs cannot be borne by the banks if the financial system is opened up to forces of international competition. The Committee recognized that the strengthening of the

financial system is the single most important pre-condition to move to Capital Account Convertibility (CAC). Drastic measures should be taken to reduce the level of NPAs. Noting the systemic dangers of some of the weak banks growing at rates faster than the system, the Committee recommended that the weak banks should be converted into what are called 'narrow banks'; the incremental resources of these narrow banks should be restricted only to investments Government securities and in extreme cases of weakness not only should such banks not be allowed to increase their advances but there would need to be a sever restraint on their liability growth. The Committee recognized that such measures are unavoidable if the financial system is to be safeguarded during the move towards CAC.

NPAs have been the most vexing problem faced by the weak banks with additions to NPAs often outstripping recoveries. A significant portion of the NPAs are chronic and / or tied up on BIFR cases. There are also loans given to State and Central public sector units which have not been repaid. The operations of Debt Recovery Tribunals are such that they have not so far made a dent in the NPA position of banks. The route of compromise has also not been very successful despite setting up of Settlement Advisory Committees. It is necessary that measures are found to ensure an early resolution of chronic NPAs. Where guarantees have been given by the Central or State governments and where these have been invoked by the banks, these demands need to be met.

NPAs – The International Experience

The problem of Non Performing Advances is not unique to India. This is a feature of banking throughout the world. The severity of the problem and approach to the problem however vary from country to country depending on the performance of the economy, general standards of education and living, philosophy of the Government to protect the financial system from turmoil through budgetary allocation of resources if warranted, corporate governance in practice, accounting and auditing standards, legal infrastructure, technological advancement and progress made in reforms in the financial system to ensure soundness and stability. Both developed and developing countries face this challenge in difference ways and only difference perhaps is that developed countries are able to absorb the problem fast without being noticed or before the impact is felt and gets spread to other segments of the economy. Developing countries try to keep the problem under the carpet and put up a brave front through some financial gimmicks of a temporary nature without any enduring result. Creative accounting practices are an

established truth in some developing countries particularly in Asian countries, to cover up the unsoundness in banking.

Restructuring of banking has been a predominant item on the agenda, in almost all developing economies, which have been willy-nilly in the process of liberalization. The literature on international experience, however, indicates that the cost on account of the problem of NPA of banks is ultimately borne by the Government irrespective of ownership of banks. In Indonesia, the problem of Non-Performing loans is acute and options are either to liquidate the bank or restructure them with capital support from Government which is estimated at roughly Rs 2700 crore. In Thailand, some of the crisis-ridden banks have been sold and some of the finance companies re swamped by bad loans accounting for a staggering 47 per cent of total lending. The Thai banks are reluctant to initiate new lending and are on their path to narrow banking. In South Korea, funds provided to the tune of Rs 2, 62,000 crore (US $ 57.6 billion) have been exhausted and another round of restructuring without delay is being contemplated. About 15 per cent of the total loans portfolio of banks in Philippines is deemed Non-Performing. Although, the Philippines banking system is regarded as sound compared with others in the region, the fact remains that the economy will not grow unless massive amounts of capital are poured into the financial system to restructure them.

In the Czech Republic, the problem of banks continues despite bailing them out by Government restoring to budgetary support to the tune of 8 per cent of GDP. In Brazil, the Non-Performing loans of banks are estimated in the range of Rs 13, 65,000 crores (US $ 300 billion).

The position of Non Performing Advances in some of the countries as per the estimates made by Ernst and Young is furnished in Table 4.

Table 1

Comparative Position of NPAs in Select Countries

(In billion US $)

Countries	NPAs	NPA as percentage of Loans	NPA as percentage of GDP

Japan	1,243	26	26
China	480	40	44
South Korea	104	16	25
Indonesia	21	60	14
India	25	16	14

Source : Ernst and Young, Business Standard dated. 12.07.2002.

Ernst Pegs, NPAs 50 per cent higher at $ 25bn-Bhupesh Bhandari Japan topped the list of countries with NPAs of $ 1,243 bn, followed by China $ 480 bn. Japan's problem of bad loans is even worse than feared. Japan's economy is till creating bad loans, as top of the mountain of problem assets that has dogged the banking system for the last decade. Japan's bad loan is exacerbated by an ineffective regulatory regime and the lack of a realistic plan. Japan's banking system is an economic black hole. Despite writing-off about Yen 60,000 bn ($ 500 bn) in bad loans and receiving millions of billions of yen from the Government, the country's banks remain fragile and riddled with bad debt. The Government's problems in clearing up the bank's balance sheets have been made far more difficult by domestic economy, together with the global slowdown, is driving firms into default. Land prices are still failing, eroding the value of collateral. And price deflation means that while nominal interest rates are low, real interest rates are significantly positive. The real burden of any given nominal level of debt rises, year after year.

Some of the proposals to remedy the situation include:

(i) strengthening the examination system,
(ii) introduction of steps for speedy foreclosure of loans,
(iii) recapitalization of banks as done in US in the 1930s.
(iv) considering procedures to ensure against adverse selection of assets and lending assistance programmes,
(v) private risk sharing to avoid further credit crisis once the bad banks are forced to self liquidate.

In China lending directed by the State is largely responsible for the burden of NPL in major banks. Official estimate puts bad loans at about 30 per cent of assets but most analysts believe the figure to be nearer 50 per cent. Bad loans elsewhere-such as at city commercial banks and rural credit cooperatives took the total to more than 50 per cent of the country's GDP in 2000, say several academics in the State think tanks. World Trade Organization (WTO) accession will introduce foreign banking

competition in stages, putting pressure on Beijing to cleanse its State banks of bad loans or condemn them to failure. Most experts believe that this process will involve the shifting of banks; bad loans to the Finance ministry's books. Song Guoquing, a professor of economics, at Peking University, believes "the cost of writing off Non-Performing loans in State banks, financing pensions and paying unemployment benefit could cause domestic debt to rise from the current 15 per cent of GDP to more than 70 per cent. If the trend continues in the current way, then China will have the same problems as Japan. The only difference is that China's political system produces bad loans much more easily than Japan's because in China there is no rule of law or checks and balances applicable to the Government. If the Chinese Government wants loans, it just takes them. The lack of separation between Government and business is also at the root of a crisis in China's rural economy, home to about 900 million of its 1.3 billion populations.

The total NPAs in the Asia Pacific region are estimated at $ 2,000 billion. Opportunity Funds (which buy out the NPAs from banks and financial institutions and then recover the dues) have brought in $ 20 bn into the Asia Pacific region, with $ 16 bn being pumped into Japan alone. These funds have earned returns ranging from 20 per cent and above on their investments.

In a study 'Rejuvenating Bank Finance for Development in Asia and the Pacific', United Nations Economic and Social Commission for Asia and the Pacific (ESCAOP) has observed that the problem of Non-Performing Loans, which reached record numbers following the Asian financial crisis of 1997, has undermined the solvency of the banking system in many countries. High levels of Non-Performing Assets are the bane of the entire banking spectrum in the Asian region. Indeed, banks in Asia are afraid to lend, companies are reluctant to borrow and the region's monetary authorities have given little or no indications as to how they will solve this credit crunch. Economic growth is consequently to remain muted across much of the region. The study adds that most countries are at present experiencing ample liquidity with low and declining interest rates but there exists a shortage of "Credit Worthy Corporate borrowers".

The problem can be seen at its worst in Argentina. The US is also not an exception with the failure of instances of giant corporate houses like Enron, World.com, etc. The consolation perhaps is that the failure has not caused widespread contagion and a severe global financial crisis due

to many years of effort promoting financial stability which have begun to bear fruit.

No country has been free of costly banking crisis in the last quarter century. The prevalence of banking system failure has been at least as great in developing and transition countries as in the industrial world by one count, 112 episodes of systemic banking crises occurred in 93 countries since the late 1970s and 51 borderline crises were recorded in 46 countries. Governments and thus ultimately taxpayers have largely shouldered the direct costs of banking system collapses.

NPAs: A Cross-nation Study

Highlights of some empirical studies on banks' performance in India and abroad having relevance to the problem of Non Performing Advances have been brought out below. The studies have covered weaknesses of banks covering profitability, Non-Performing Loans, efficiency in operations, etc. they have however, not come out with any lasting/workable solution to contain the problem of NPAs and at the same time strengthening the Balance Sheets of banks recognizing formation of some NPAs by the very nature of banking business. Although some international studies have been included, it has to be recognized that cross-country comparisons are often difficult to interpret because the regulatory and economic environment encountered by financial entities are different across nations and also because the level and quality of services associated with deposits and loans in different countries could differ.

A study relating to the performance of Indian Banks, (Ojha, 1987) made a multivariable international comparison of Public Sector Banks' productivity and profitability by suing data relating to 16 difference banks for the year 1985. The major finding observed pertain to high level of interest income compared to non-interest income. This high level preponderance of traditional banking business in India stressed the need for diversification of banking business.

Andreas Nicholas Philippines has used Hierarchical Ordinary Lest Square Regression to test the relationship between the rates of change of Net Income (NI), Loan Loss Provisions (LLP) and Non-Performing Loans (NPL) and the rate of change of stock prices, for each of the five time periods. The functional form of Regression equation is derived by

combining a new simple stochastic process (according to which the variable behave) and a valuation mechanism that relates Stock Prices (SP) to NI, LLP and NPL. The findings suggest that Non-Performing Loans is an important variable in explaining Banking Holding Companies (BHC's) stock prices. Its importance is evaluated after NI and LLP are taken into consideration. NI is the most important explanatory variable, while LLP appears insignificant.

A paper by Kim Myung-Sun examines the effect of a regulation change on management incentives and accrual estimates. The paper on the impact of the 1989 change in Bank Capital Standards and Loan Loss Provisions investigates whether managers of banks with loan capital ratio reduce their banks' loan loss provisions after the 1989 change in capital standards. The loan loss provision has a positive effect on the capital ratio prior to 1989 and negative effect after the change in capital standards in 1989. The model is designed to test the hypothesis that the loan loss provision captures the capital ratio management incentives after controlling of:

1. non-discretionary factors in the loan loss provision decision such as gross loans and Non-Performing Loans.
2. earnings management incentives, and
3. interest rates.

The results support the hypothesis that managers of banks with low capital ratios reduced loan loss provisions during the 1990-92 period compared to the 1985-1988 period. Banks with high capital ratio do not exhibit such a change. As hypothesized, bank managers change their behavior in response to the change in the capital standards. Test results indicate that the findings are not due to one specific year's LLP increase. In contrast, the change in the capital standards is not related to the loan loss provision decision of banks with capital ratios. A cross-sectional analysis provided evidence of a negative relation between the capital ratio and discretionary LLP during 1985-1988 and a weak positive relation between the two variables during 1990-1992.

Although the 'size effect' on the LLP decision is not explicitly hypothesized in this study, the size variable has been found to be constantly positive. It appears that the larger the bank, the more like it is to set a higher LLP, which results in a lower income. This result is constant with Watts and Zimmerman's (1986) 'Political Cost Hypothesis'. The results are also consistent with income smoothing.

In addition to providing evidence of Accounting Number Management in the banking industry, the said paper has further implications. One implication of the results is related to the fact that the different definitions of capital under Generally Accepted Accounting Practices (GAAP) and under 'bank regulations' have created a unique incentive to manage LLP or 'Bad Debt Expense' in a way different from that in other industries. The resulting LLP and Earning represent a different aspect of a firm within the banking industry and also of the banking industry as compared to other industries. The results should encourage Regulators and Accounting Standard Setters to consider the Incentive Effects of Regulation Change on Accounting Decisions. This might prevent unanticipated consequences of a regulatory change that might disrupt efficiency in applying the regulation. Auditors can also utilize the results to reduce their exposure to litigation.

A study by P.Secured Sarkar and Abhiman Das examines the inter-bank performance differences in the efficiency of banking sector with respect of profitability, productivity and financial management, for the year 1994-95. For each area of the performance criteria, area specific Efficiency index has been worked out based in 15 indicators, using Principal Component Analysis. The result shows that there is a wide variation in efficiency among the banks according to their ownership pattern. The performance of Public Sector Banks was relatively poor compared to other bank groups. While a wide variation of performance among the foreign banks was discernible, the (PSBs) resembled more or less a homogeneous group.

In the study on Risk Happens-The Risk and Performance Relationship in Banking, conducted in 1996, Ross Gary Howard, has observed with reference to Non-Performing Loans that Commercial bank experience both expected and unexpected outcomes from the loan approval decision process he also makes the comment that banks never approved a loan with the intent that loans will become a Non-Performing asset; insight into why and where Non-Performing Loans will occur, is important, while expressing his inquisitiveness as to how the decision makers have simply factored in Non-Performing Loans as a cost of doing business and not as a particular risk outcome. In his concluding remarks he has highlighted that growing banks were observed to have a growing number of Non-Performing Loans. The idea that an organization might learn from its prior decisions is not evident as banks continue to accumulate Non-Performing Loans in the normal course of business.

Notwithstanding the substantial freeing of resources from statutory pre-emption, credit off take has been subdued and (PLRs) are strictly downwards. Banks have generally found investment in Government securities worthwhile. Perhaps, a solution to this could be found in the reduction of NPAs of banks, which implies a more careful credit appraisal and regular follow-up. It must be recognized that the purpose of banks is to take risk through the extension of credit to business and households. This is so vital to the growth and stability of the economy.

Lighter and Lowell in their study in 1998 observed that under right conditions financial liberalization could enhance financial systems' ability to increase profits and finance economic growth.

The paper on profitability in PSBs evaluates inter-bank variability of profit among Public Sector Banks during 1992-98 ensuing sequential decomposition models for profitability analysis. A reduction in the burden of arising working funds in the post reform period due to a gradual shift away from traditional banking, a distinct risk aversion indicated by the preference for investments over advances in bank portfolios and increased competition reflected in convergence in bank-wise performance in the reform period are among the principal findings. It was, however, warned by way of caution that in the near future public banks need to focus more on loans and advances as a rational response to the risk return trade off facing commercial banking in India.

The Indian Banking Sector is characterized by both a high average Non Performing Advances in total bank advances and a high dispersion between banks. This paper presents the findings of a formal attempt to explain inter-bank variations in NPAs for the year 1996-97. The specification tests for the impact of region of operation on domestically owned banks, as measured by percentage branches in each of a set of state clusters. One clusters of three eastern and seven north-eastern regions caries a robust and statistically significant negative coefficient. These findings bear out those of Demirgnc-Kunt and Huizin on the significance of the separating environment for bank efficiency. No sustainable improvement in the performing efficiency or domestic banks is possible without prior improvement in the enforcement environment in difficult regions of the country. Another finding of some importance is that it is not foreign ownership in and of itself so much as the banking efficiency and technology correlates of the country of origin of the foreign bank which determine NPA performance in the Indian environment.

The main purpose of bank regulation is the maintenance of a sound banking system, which is usually narrowly interpreted to mean 'prevention of bank failure'. To this end, regulators examine the riskness of assets and adequacy of capital. But do rigid capital adequacy ratios ensure adequate bank capitalization in reality? Alternatives such as value-at-risk and pre-commitment model have been used in some developed countries. India needs theoretical analysis of these models and empirical data before it can consider a shift from the current capital regulatory arrangements.

In a study on 'Declining Market Share' of Public Sector Banks, it has been observed that PSBs, still a dominant force in the Indian finance system, are losing their market share of business at the rate of more than one per cent per annum during the post-reform (1992-99) period. PSBs were losing ground heavily in metro market segment which warrants a serious introspection. Not only was the erosion visible in deposits and advances but also in the spread, non-interest income and profit. One hopes that the fast changing market scenario will compel the PSBs to shed their organizational rigidities and reorganize themselves, including mergers and acquisitions among themselves, to stay put and retrieve lost ground. Capital market fitness of PSBs is the need of the hour. It is time that the owner, the management and trade unions come together and act in unison to ensure remaining operationally efficient.

A study by Mr. P. Ganesan examines the determinants of profitability of Public Sector Banks in India by an empirical estimation of profit function model which showed that interest cost, interest income, deposits per branch, credit to total assets, proportion of priority sector advances and interest income loss, are the significant determinants of profits and profitability of Indian Public Sector Banks.

It is observed from the analysis of risk factors, that the Coefficient of Credit to Total Assets Ratio is negative and statistically insignificant in profitability function. This implies that overall performance of branch credit flow was not satisfactory and hence credit flow into the economy could not produce any positive impact over banks profitability due to higher NPA. The costs incurred on Defaulted and Other Loan Assets are higher than the expected low costs. However, the coefficient value of credit to total assets in profit function assumes positive sign with statistical insignificance.

The study on Non-Performing Loans of Public Sector Banks shows a panel regression on the definitionally uniform data available for a five year plan ending in 1999-2000. The exercise is confined to 27 PSBs. So as to investigate variations within a class that is homogenous on the ownership dimension. The Exercise Groups the banks with higher than average NPAs into those explained by poor operating efficiency and those where the operational indicator does not suffice to explain the higher level of NPAs and leaves an unexplained intercept shift. Two of the three weak banks identified by the Verma Committee viz., the Indian Bank and the United Bank of India, fall in this category. Recapitalization of these banks with operational restructuring may therefore not be the solution, since there is clearly a residual problem even after controlling for operating efficiency. For banks operating in regions where there has been marked industrial decline, such as United Bank of India with its branch concentration in West Bengal, recapitalization with operational structuring amounts to use of public funds with no discernible public purpose. Closure with liquidation of assets including real estate at market value should prove to be far more cost effective even with full depositor protection.

➢ **Legal Measures of Recovery:**

The expression 'immovable property' is defined in section 3 (26) of the General Clauses Act, which is not exhaustive. It states that an immovable property shall include land, benefits to arise out of land and things attached to earth, or permanently fastened to any thing attached to the earth.

The transfer of property Act defines the phrases 'attached to earth' in section 3, Transfer of Property Act but gives no definition of immovable property beyond excluding standing timber, growing crops and grass. The expression 'attached to earth' means:

(a) Rooted in the earth, as in the cases of trees and shrubs;
(b) Imbedded in the earth, as in the case of walls or building;
(c) Attached o what is so imbedded for the permanent beneficial enjoyment of that to which it is attached.

➢ **Civil Suit:**

(I) Application for Attachment of Immovable Properties

Rule 13 of Order XXI of Code of Civil Procedure 1908, states that applications for attachment of immovable property belong to the judgment-debtor shall contain the following details about the property:

(a) a description of property sufficient to identify the property;
(b) in case of property can be identified by boundaries or numbers in a record of settlement or survey, the application must contain a specification of such boundaries or numbers;
(c) a specification about the share or the interest of the judgment-debtor to the best of the knowledge of the decree-holder.

Rule 14 of Order XXI of Code of Civil Procedure 1908 requires that where he land to be attached is registered in the office of the collect, the court may require the decree-holder, to produce a certified extract from the register of such office, specifying the persons registered as proprietors of or possession any transferable interest in the land or its revenue. The certified extract shall also give details of the shres of the registered proprietors.

(ii) Attachment before judgment

Rule 5, Order XXXVIII of Code of Civil Procedure 1908, and section 19 (13) of Reconstruction of Debtors due to Banks and Financial Institutions Act,1993, provides for attachment of property, before judgment is pronounced, where the court is satisfied by affidavit or otherwise, at any stage of the suit, that the defendant with an intent to obstruct or delay the execution of any decree is bout to dispose of the whole or any part of his property or is about to remove the whole or any part of his property from the local limits of the jurisdiction of the court. The court may in such circumstances direct the defendant, within the stipulated time, either to furnish security in such same as may specified in the order or to appear and show cause as to why he should not furnish security.

The main object of an attachment before judgment is to enable the plaintiff to realize the amount of the decree, if one is eventually passed, from the defendant's property. Further, object of this provision is to prevent a decree from becoming in fructuous. It is incumbent upon the plaintiff to state the grounds on which he entertains the belief or apprehension that the defendant would dispose of or remove the property, or, to give the source of his information and belief in the matter through an affidavit.

The following are the guiding principle in deciding an application for attachment before judgment-

(1) An order under Order XXXVIII can be issued only if circumstance exists as are stated therein to the satisfaction of the court.

(2) The court would not be justified in issuing an order to attachment before judgment, or for security, on the mere assumption that no harm would be done thereby or that the defendants would not be prejudiced.

(3) The affidavit in support of the contentions of the applicant should not be vague and it must be properly verified. Where it is affirmed true to knowledge or information, it must be stated as to which portion is true to knowledge and the source of information should be disclosed and the grounds for belief should be stated.

(4) A mere allegation that the defendant is selling off his properties is not sufficient. Particulars must be stated.

(5) An order of attachment before judgment is a drastic remedy and the power has to be exercised with utmost care and caution, as it may be likely to ruin the reputation of the party against whom the power is exercised. As the court must act with the utmost circumspection before issuing an order of attachment, the affidavit filed by the applicant should clearly establish that the defendant, with an intention to obstruct or delay the execution of the decree that may be passed against him, is about to dispose of the whole or any part of his property.

(6) A mere mechanical repetition of the provisions in the Code or the language therein without any basic strata of truth underlying the allegation or vague and general allegation that the defendant is about to dispose of the property or to remove it beyond the jurisdiction of the court, totally unsupported by particulars, would not be sufficient compliance with Order XXXVIII, Rule 5 of Code of Civil Procedure.

(7) An attachment before judgment is not a process to be adopted as a matter of course. The suit is yet to be tried and the defendant of the defendant is yet to be tested. At the nebulous juncture the reliefs, its grant, as per the provisions of the Code, stand satisfied. This process is never meant as a lever for the plaintiff to coerce the defendant to come to terms. Hence utmost caution and circumstances should guide the court.

Rule 6, Order XXXVIII of Code of Civil Procedure 1908, further state that where the defendant fails to show cause why he should not furnish security, or fails to furnish security, required by the court, within the time fixed, the court may order the property to be attached. Where however the defendant shows causes or furnished security, the court

shall order the attachment to be withdrawn or make such other order as it thinks fit.

Rule 7, of Order XXXVIII of Code of Civil Procedure, 1908, the mode of making of attachment incases of attachment of property prior to judgment is similar to one to be followed for attachment of property in execution of decree which is discussed herein below.

(iii) Attachment of Immovable Property in Civil Court Proceedings

Rule 54 of Order XXI, of Code of Civil Procedure, 19108, states that an immovable property shall be attached by an order prohibiting the judgment debtor from transferring or charging the property in any way, and all persons from taking any benefit from such transfer or charge the order attaching the property shall also require the judgment-debtor to attend court on a specified dare to take notice of the date to be fixed for settling the terms of proclamation of sale.

Mere passing of an order in the file of the court is not sufficient. It is further required that the order of attachment be proclaimed at some place on or adjacent to such property by beating of drums or other customary modes. The copy of the order shall be affixed at the following places:

(a) on a conspicuous part of the property;
(b) on a conspicuous part of the court house;
(c) on the office of the collector of the district in which the land is situated (where the property is paying revenue to the government); and
(d) In the office of the Gram Panchayat (where the property is situated in a village).

Rule 54, Order XXI, Code of Civil Procedure, 1908, is subject to the High Court amendments. The amendments pertain only to the part of proclamation stated in sub rule (2) of rule 54. The amendments have been brought by the High Courts of Allah bad, Andhra Pradesh, Mumbai, Kolkata, Delhi, Gauhati, Gujarat, Himachal Pradesh, Karnataka, Kerala, Madhya Pradesh, Tamil Nadu, Orissa, Patna and Punjab.

Formalities prescribed by Order 21, Rule 54 are mandatory. In order to create a valid attachment, those formalities must be complied with. The purpose of the rule is to make the judgment debtor aware that attachment has been effected and that he should not make any transfer thereafter.

➢ Immovable Property Exempted from Attachment:

Section 60 of Code of Civil Procedure prescribed the details of the properties, which are exempted from attachment. In this chapter we are dealing with land, houses and buildings, hence the categories of properties which are exempt from attachment are given herein below:

(a) Houses and Buildings belonging to an Agriculturist

Section 60(c) of Code of Civil Procedure, 1908 provided that houses and buildings belonging to an agriculturist, or a laborer or a domestic servant are exempt from attachment, provided the house and the building are wholly occupied by such agriculturist, laborer or a domestic servant.

Besides the houses and buildings, this provision also exempts from attachment, the material and the sites thereof and the land immediately appurtenant thereto and which is necessary for the enjoyment of the provided under clause (c) of sub-sc (1) of section 60, CPC shall not be available where the attachment or sale is in pursuance of execution of decrees of rent for any such house, building, site or land.

The expression 'agriculturist' has been defined in Explanation V of section 60, Code of Civil Procedure, as a person who cultivates land personally and who depends on his livelihood mainly on the income from agricultural land, whether as owner, tenant, partner or agricultural laborer.

An agriculturist as defined in clause V above shall be deemed to cultivate land personally, if he cultivates the land-

(1) by his own labour, or,
(2) by the labour of any member of his family, or
(3) by servants or laborers on wages payable in cash or in kind (not being as a share of the produce), or both.

The right under the above provision is a personal right available to an agriculturist or a laborer or a domestic servant. It is neither heritable nor alienable. It can be enforced only during the lifetime of the person who is entitled to claim the right and after the death of the person concerned; the said rights cease to exist. The protection given to the agriculturist against attachment of his residential house is based upon the public policy of the state as any interruption of agricultural operations conflicts with national interest and it may led to a fall in agricultural production. Such policy of State cannot be defeated and any waiver of such a right is opposed to public policy.

The State of Himachal Pradesh has introduced amendments in clause (c), sub-section (1), section 60 of Code of Civil Procedure. The Amendment of Himachal Pradesh extends the exemptions from the attachment also to compensation paid for such houses and buildings including compensation for the materials and the sites and the lands referred to above, acquired for a public purpose. Another clause (cc) which has been introduced in the State of Himachal Pradesh extends the compensation paid for agricultural lands belonging to an agriculturist and acquired for a public purpose. The difference between clause (c) and clause (cc)is that in the former it is the compensation for the house and buildings whereas, in the latter it is the compensation for the land.

Similarly amendments have also been introduced by the State of Punjab, which have been extended in the States of Chandigarh, Delhi and Haryana. The effect of the amendment in clause (c) is the words 'occupied by him' at the end of clause (c) is substituted by the following words 'not proved by the decree holder to have been let out on rent to persons other than his father, mother, wife, daughter in law, brother, sister or other dependants or left vacant for a period of a year or more'. This amendment extends the scope of exemption of to those housed and buildings which are either in occupation of the agriculturist or a laborer or domestic servant or the relations stated in clause (c) of the Punjab Amendments.

(b) Exemption of Attachments in Respect of Residential Houses and Buildings

The State of Punjab has also inserted clause (ccc) which extends the exemption from attachment to houses and buildings not belonging to the agriculturist, provided that the house seeking exemption is one main residential house and buildings attached to the main residential house. Further, the house should belong to the judgment-debtor and must be in his occupation. Needless to say this, amendment extends to states of Chandigarh, Delhi and Haryana, and bring lots of property out of the reach of the creditor to recovery their dues through execution of the decree

Where however, the said main residential house and buildings attached to it is specifically charged with the debt sought to be recovered, like through mortgage and charge under section 58 and section 1000 of the Transfer of Property Act respectively, the benefits of clause (ccc) shall not be available to the judgment-debtor. Therefore, it means if the creditor have secured their debt by creating an interest in their favor, the chances of their recovering due are higher than the cases where the loan/due are not secured.

(c) Interest of a lessee of a residential building

Clause (kc) of sub-section (1) of section 60 of CPC, 1908, states that the interest of a lessee of a residential building to which the provisions of law for the time being in force relating to control of rents and conditions apply is also exempt from attachment. Thus, the tenancy rights of a judgment-debtor cannot be attached towards the satisfaction of money decree. The exclusion or property under this clause is specifically applicable only to residential premises and not to premises used for non-residential purposes.

(I) Civil Court Proceedings

Rule 58 of Order XXI of Code of Civil Procedure 1908, deals with objections filed by the third parties and not the parties to the suit. He parties to the suit shall file objections to the attachment of the property under section 47 of the Code of Civil Procedure 1908.

(a) Thirty Party Objections

Rule 58 is attracted in cases where any claim is preferred or any objection is made to the attachment of any property, attached in execution of a decree. The sole ground available for challenge is that the property attached is not liable for attachment. The objection or the claim shall be maintainable on the above stated ground irrespective of the fact, whether the attachment is prior to decree or before the decree

The claim or the objection shall not be entertained in the following circumstances:

(i) Where before the claim is preferred or objection is made, the property attached has already been sold; or
(ii) Where the court considers that the claim or objection was designedly or unnecessarily delayed.

The court shall on receipt of objection or claim adjudicate the same in accordance with the provisions of this rule. The court after determining such objection or claim may pass any of the following orders:

(1) Allow the claim or objection and release the property from attachment either wholly or in part;
(2) Disallow the claim or objection;
(3) Continue the attachment subject to any mortgage, charge or other interest in favor of any person;
(4) Pass any such order in the circumstances of the case as it deems fit.

If however, for some reasons, the court refuses to entertain the claim or objection, the party, who is aggrieved by such order, may institute the suit to establish the right, he claims to the property in dispute.

(b) Objection by Parties to the Suit

Where the objection or claims are preferred relating to execution, discharge or satisfaction of the decree, by the parties or their representatives to the suit, in which the decree was passed, the objections are filed under section 47, of CPC 1908. The question whether a person is or is not a representative of a party, for maintaining the objection under this section is also to be determined by the court, hearing the objection or claim.

A plaintiff whose suit has been dismissed and a defendant against whom a suit has been dismissed are parties to suit.

Similarly, the auction purchaser of a property is also a party to the suit. All questions relating to the delivery of possession of such property to such purchaser or his representative shall be deemed to be questions relating to the execution, discharge or satisfaction of the decree.

- **Procedure followed for Recovery:**

Once the objection or claim as stated above, filed either under section 47 or Odder XXI, Code of Civil Procedure 1908 are dismissed, the civil court, shall proceed to take steps for selling of the property attached to recover the money due to the decree-holder. Rule 64 of Order XXI, CPC 1908, provides that any court executing a decree may order that the property or any portion of the same, attached in the manner stated above, may be sol. The court may order only a portion of the property to be sold where it is of the view that only a portion may be sufficient to satisfy the decree. The proceeds of such sale or a sufficient portion thereof shall be paid to the decree-holder. The balance, if any, shall be reimbursed to the judgment-debtor.

Proclamation of Sale

Civil Court Proceedings

Rule 65, Order XXI, CPC 1908, states that in normal circumstances, every sale in execution of a decree, shall be conducted by an officer, of a court by any such person as the court may appoint in this behalf. Normally, the sale shall be made by public auction. There may be circumstances, where the sale may not take place by the officer of a

court or by a public auction, illustratively, where the property to be sold are shares of a corporation. In this chapter, since we are dealing with attachment and sale of immovable property, the primary focus shall be on land, houses and building etc.

A High Court Amendment has been introduced by the State of Madhya Pradesh in Rule 65, Order XXI, CPCP 1908, wherein it is provided that the officer or person so appointed for conducting the sale of the attached property, shall be competent to declare the highest bidder as purchaser at sale.

Rule 66, of Order XXI, CPC, 1908, states that the proclamation of the intending sale shall be made in the language of the court, which is ordering sale of a property by public auction in execution of decree.

The proclamation shall be drawn up after due notice to the decree-holder and the judgment-debtor. It shall not be prepared without notice to the judgment-debtor, however, where the date of setting the terms of proclamation has been given to the judgment-debtor, by means of an order to give notice under Rule 66 to the judgment-debtor.

The proclamation shall state the time and place of sale and shall also specify as fairly and accurately as possible the following details:

(a) The details of the property to be sold;
(b) Where a part of the property is sufficient to satisfy the decree then it shall provide the details of such part of the property;
(c) The details of the revenue assessed upon the estate or part of the estate, if the property to be sold is an interest in the estate, paying revenue to the government;
(d) The details of any encumbrance to which the property is lible, like mortgage, attachment etc;
(e) The details of the amount for the recovery of which the ale is ordered; and
(f) Every other thing, which the court considers materials for a purchaser to know in order to judge the nature and value of the property.

The court is not required to enter into the proclamation of sale, its own estimate of the value of the property, however, it is incumbent upon the court to include the estimate in the proclamation of sale, if any, given by either or both the parties. It shall be open to the court to summon any person whose present is required for the purpose of ascertaining the matter to be specified in the proclamation. The person so summoned, may be called upon by the court to produce any document in his

possession or power relating to ascertainment of matters in the proclamation of sale.

Rule 67, Order XXI, CPC, 1908, states that the proclamation shall be made and published by proclaiming it at some place on or adjacent to the attached immovable properties by beat of drums or other customary mode. A copy of such proclamation shall also be affixed on a conspicuous part of a property or upon a conspicuous part of a court house. Where the property is land and is paying revenue to the government, the proclamation of sale, in addition to the above stated, shall also be proclaimed in the office of the collector of the district, in which the land is situated. Where the land attached is a part of the village then the proclamation of sale shall also be made in the office of the gram panchayat. The proclamation shall be made similar to the manner prescribed in Rule 54 of Order XXI, CPC 1908, for attachment of property, stated herein above.

The High Court of Patna has amended sub-rule 1 of Rule 67, Order XXI, CPC 1908, to the effect that the court may, on an application of the decree holder, order proclamation and publication of sale simultaneously with order of attachment under Rule 54, Order XXI, and CPC 1908. The Amendment of Patna is adopted by the Orissa High Court.

Where for the purposes of sale, the property is divided in lots, it shall not a be necessary for making separate proclamations for each lot, unless the court is of the opinion that a proper notice cannot otherwise be given. The High Court of Madras has amended this rule to the effect that it shall be necessary to publish the proclamation of each lot separately. The Amendment of the Madras High Courts is also adopted by High Court of Andhra Pradesh, Karnataka and Kerala.

- **Execution of Decrees:**

Recovery of money through the attachment and sale of immovable properties the most commonly employed method of executing the Decree. The reason being that value of the property appreciates with time as against moveable properties, discussed in the subsequent chapters, where the values of the property depreciate with the passing of the time. This menace the recovery is also riddled with most grave and complicated legal issues. In this chapter, we shall deal with the manner of attachment of immovable property and the sale of the same towards the satisfaction of the decree. Along with this we shall also discuss the objection faced by the decree holder, before he could enjoy the fruits of the decree passed in his favour.

Sale of an immovable property in execution of a decree and recovery certificate shall be conducted by an officer of a court on any person appointed in this behalf. Rule 68 of Order XXI, of CPCP 1908, states that the sale of an immovable property shall not take place unit after the expiration of at least 15 days calculated from the date on which the copy of proclamation has been affixed on the court house or the Judge ordering the sale.

- **Adjournment or Stoppage of Sale:**

The sale may be adjourned or stopped in exercise of the discretion vested upon the court or the officer conducting such sale under Rule 69, of Order XXI, CPC 1908. If the sale is adjourned, it shall be adjourned to a specified date and hour. The court and the officer conducting the sale may record their reasons for such adjournment.

The sale may be postponed under Rule 83 of Order XXI, CPC 1908, if the judgment-debtor can satisfy the court that there is a reason to believe that the decrial amount may be raised by the mortgage or lease or private sale of such property it may also be postponed if the judgment-debtor is able to satisfy the court that some portions of the attached property may be used for raising the funds through mortgage or lease or private sale of such portions. Further, if the judgment-debtor is able to satisfy that he has some other immovable property, which may be sold, mortgaged or leased, the court may postpone the ale on such terms as it deems fit. The postponement of sale on the ground of arranging funds shall be done on the condition that all monies payable under such mortgage, lease or sale, shall be paid not to the judgment-debtor but in the court except where a decree holder is entitled to set off such money on account of opting to bid for or purchase the property.

Where a sale is adjourned or stopped in exercise of discretion by the court or the officer conducting the sale for a period long than 30 days of fresh proclamation for sale shall have to be made in the manner of which is discussed herein above. The condition of fresh proclamation may be waiver, only if, the judgment-debtor consents to waive Income Tax

Restriction on Sale by Certain Class of People

Officer on Duty

The sale so conducted is to be conducted by public auction, so as every one is free to participate in the same, however on account of Rule 73, of Order XXI, CPC, 1908, no officer or other person, who have been given the duty to conduct the sale, shall acquire or attempt to acquire any

interest in the property old. The officer conducting the sale is not only debarred directly but also indirectly from participating in the bid.

- **Decree Holder:**

Restrictions have also been placed upon the decree-holder and the mortgage to bid and buy the immovable property in the public auction conducted for sale of immovable property, in execution of decree Rule 72, of Order XXI, CPC 1908, states that a decree-holder cannot bid for or purchase the property, without the express permission of the court. It is thus incumbent upon the decree-holder to seek specific permission to participate in the bid or purchase the property. The decree-holder has an advantage over the other builders; in the event they chose to participate in he bid or purchases the property, which is that the purchase money is set off with the amount due on the decree. The court executing the decree shall record the satisfaction of the decree in whole or in part accordingly.

The High Court of Patna has amended Rule 72, Order XXI, CPC, 1908, with the effect, that the decree-holder shall not as a matter of rule be precluded from bidding for or purchasing the property, thereby taking a position diametrically opposite to normal rule of CPC. The rule of Patna High Court permits the decree-holder to bid and purchase the property as a matter of rule, the decree-holder as an exception is not permitted to participate, if the court by an express order prohibits him from participating. The Orissa High Court has adopted the rule framed by the Patna High Court.

- **Mortgagor**

Similarly Rule 72A of Order XXI, CPC 1908, restricts the mortgage to bid for or purchase the property sold in auction conducted for execution of decree. The mortgage may bid or purchase the property where the court has permitted him to do so.

The court before granting the leave to a mortgage shall fix a reserve price for the mortgage. The reserve price shall ordinarily be fixed at a price shall not less than the amount due for principal, interest and costs in respect of the mortgage, if the property is sold in one lot. If however, the property is sold in more than one lot, the reserve price shall not be less than such sum as shall appear to the court to be properly attributable to each lot in relation to the amount then due for principal, interest and costs on the mortgage.

The object of the rule is to prevent a mortgagee purchaser from taking an undue advantage by purchasing the mortgaged property at a lower price

and then pursuing other remedies to recover he balance of the amount of the decree.

Auction Purchaser

The highest bidder at the auction shall be declared to be the purchaser of the immovable property. The said purchaser is required under Rule 84, Order XXI, CPC 1908, to pay immediately after being declared as a purchaser, a sum equivalent to 25% of his purchase money, which was being bid at the auction. The money is to be deposited to the officer or any person conducting the sale. In the event of money, not being deposited, the property shall forthwith be resold.

The balance of the purchase money shall have to be paid by the purchaser into court within 15 days from the sale of the property. The decree-holder who chooses to become the purchaser of the property shall have the advantage of any set off, to which he may be entitled under Rule 72, Order XXI, and CPC 1908. The requirement of Rule 85, Order XXI of CPC, 1908, is mandatory. Its non-compliance renders the sale a complete nullity.

The High Courts of Andhra Pradesh, Bombay, Gujarat, Kerala, Madhya Pradesh and Madras have carried out certain amendments in Rule 85, Order XXI, and CPC 1908.

Where a default takes place in payment of the balance amount, the court may under rule 86 of Order XXI, CPC 1908, after defraying the expense of the sale, allow the amount to be forfeited by the government. The property after forfeiture, shall bee resold and the defaulting purchaser shall lose all the claims to the property or to any part of the sum for which it may subsequently be sold. A fresh proclamation needs to be made for resale of the property under rule 87, Order XXI, CPC 1908, if the resale is caused due to default on the part of the auction purchaser to deposit the balance sum.

Where a sale of an immovable property is set aside in a manner discussed herein below, the purchaser shall be entitled to an order for repayment of his purchase money under Rule 93, Order XXI, CPC 1908, with or without interest as the court may direct against any person whom it has been paid. If, however, the sale is made absolute, the court shall issue a certificate under Rule 94, of Order XXI, PCP 1908, specifying the property sold and the name of the person who at the time of the sale is declared to be the purchaser. Such a certificate shall also bear the date on which sale became absolute.

Setting Aside of Sale in Execution of a Decree

A set of an immovable property may be set aside under Rules 89, 90 and 91 of Order XXI, CPC 1908. The grounds for setting the sale are following:

(i) Setting aside of sale on deposit of money;
(ii) Setting aside of sale on ground or irregularity or fraud;
(iii) Setting aside of ground of judgment-debtor having no saleable interest.

Each of the grounds for setting aside of sale is briefly discussed herein below:

Setting Aside of Sale on Deposit of Money

An application for setting aside sale under Rule 89, Order XXI may be made by any person claiming an interest in the property by depositing in court-

(a) A sum equal to 5% of the purchase money for payment to the purchaser; and
(b) The amount specified in the proclamation of sale for payment of the decree-holder less any amount, which may, since the date of proclamation have been received by the decree-holder.

The application for setting aside the sale under Rule 89, Order Xxi may be made after the property is sold, but before the sale is on freedom in favor of the auction purchaser.

The application for setting aside the sale by deposit of money is maintainable by-

(a) any person owning the property; or
(b) any person holding an interest in such property-by virtue of a title acquired before the sale.

The person contemplated under Rule 89, Order XXI includes the judgment-debtor and also persons having a lesser interest, such as a lessee, mortgagee or any other person, who has a inchoate title to the property or any person who is interested in protecting the property on account of his being in possession or otherwise in pursuance of an incomplete transfer of property.

The High Courts of Andhra Pradesh, Bombay, Karnataka, Kerala and Madras have amended Rule 89, Order XXI, and CPC 1908, which general deals with the condition of deposit as stated in Rule 89.

Setting Aside of Sale on Ground of Irregularity or Fraud

The sale of an immovable property may be set aside on may be set aside on ground of material irregularity or fraud in publishing or conducting the sale. The application for setting aside sale on this ground may be made by any of the following persons:

(a) the decree-holder;
(b) the purchaser;
(c) any other person entitled to share in a ratable distribution of assts; or
(d) any person whose interest is affected by the sale.

The sale on grounds of irregularity or fraud may be set aside under Rule 90, Order XXI, and CPC 1908. On a plain reading of Rule 90, Order XXI three factors emerge, which require to be taken note of in the matter of setting aside the sale of immovable property namely;

(a) material irregularity and fraud in publishing or conducting the sale;
(b) the court dealing with such an application is satisfied that the applicant has sustained substantial injury by reason of such an irregularity or fraud; and
(c) no application would be entertained upon a ground which the applicant could have taken on or before the date of drawing up of the proclamation of sale.

The expression 'material irregularity in the conduct of the sale' must be benignly constructed to cover the climax act of the court accepting the highest bid. Since the court itself conducts the sale, its duty of the court is to apply its mind to the material factors bearing on the reasonableness of the price offered. Upon failure to apply its mind to this aspect of the conduct, conduct of the sale may amount to material irregularity.

Material irregularity of fraud standing by itself is no ground for setting aside the sale, it must be accompanied by substantial injury occasioned irregularity or fraud and a substantial injury must be proved. The expression 'conducing the sale' refers only to the action of the officer who holds the sale and expression does not apply to anything done antecedent to the order of sale.

The High Court of Allah bad has amended Rule 90, Order XXI, CPC, by adding a proviso to the rule stating that an application to set aside a sale shall not be entertained unless the applicant deposits such amount not exceeding 12 ½ % of the sum realized by the sale or a security is furnished to the satisfaction of the court. The deposit of the money of submission of the security may be exempted if the court for reasons to be recorded dispenses with the same. The High Courts of Patna and Orissa have also adopted similar amendments. The High Courts of Madras and Andhra Pradesh provide for furnishing of security to the satisfaction of the court for deposit of an amount equivalent to the amount mentioned in the sale warrant or that realized of the sale, whichever is less. The High Courts of Calcutta and Gauhati have also amended rule 90 to the effect that a sale shall not beset aside on the ground of any defect in the proclamation of the sale at the instance of any person who after notice did not attempt the drawing of a proclamation. The sale shall also not be set aside on the an app; of a person who was present at the time of proclamation of the sale but did not challenge of defect at the time.

Setting Aside of Sale of Grounds of Judgment Debtor having no Saleable Interest:

The purchaser at the auction of immovable property in execution of a decree may also apply to the court under Rule 91, of Order XXI, CPC 1908, for setting aside of sale on the ground that the judgment-debtor has no saleable interest in the property sold. Such an application must be made before the confirmation of the sale. A purchaser is not entitled to have a sale set aside on the ground that the judgment-debtor had a saleable interest in a very small portion of the property but no such interest in the measure portion of the property.

Confirmation of Sale

In the proceedings pending before the civil court, the sale of the immovable property shall be confirmed under Rule 92, Order XXI, CPC 1908, fewer than two circumstances, namely:

(a) Where no application is made under Rule 89, 90 and 91 CPC 1908 and;
(b) Where though the application is made under rules 89-91, CPC 1908, but that application is disallowed.

Likewise, in the proceedings before the debt recovery tribunal, the sale shall be confirmed under Rule 63, Second Schedule Income Tax Act, 1961, if no application is made under Rules 60, 61, and 62, Second Schedule, Income Tax Act, 1961. The sale shall also be confirmed, if the application moved under Rules 60, 61 and 62 is made but is disallowed.

Certificate of Purchaser

Rule 94, of Order XXI, CPC 1908, states that where a sale of immovable property has become absolute, the court shall grant a certificate to the purchaser. The certificate shall specify the details of the property sold and the name of the person who is declared to be the purchaser. It shall also bear the date on which the sale became absolute. The High Court of Allah bad has amended Rule 94 by inserting a sub-rule 2, with the effect to include transfer, otherwise than by sale. The High Court of Bombay by way of amendment has required that the sale certificate shall also state the amount of purchase money. The High Court of Madhya Pradesh has adopted the amendment of Bombay High Court. The High Court of Patna and Orissa have also carried out amendments in rule 94 of Order XXI, CPC 1908, which deals with the filing of sale certificate stamp.

With regarding to proceedings before the debt recovery tribunal, Rule 65, Second Schedule Income Tax Act, 1961, states that the tax recovery officer shall grant a certificate to the purchaser, the certificate shall include description of the property sold, name of the person, who has been declared to be the purchaser and also the date on which the sale became absolute.

Possession of Immovable Property:

The purchaser after the confirmation of the sale and grant of sale certificate has to take the possession of the immovable property from the person in possession of the property. The property may broadly fail into the possession of the following class of people-

(1) Judgment-debtor in person;
(2) Some other persons on behalf of judgment-debtor;
(3) Some person claiming under a title created by the judgment-debtor after attachment;
(4) Tenant.

The civil court may, on an application of the purchaser, under Rule 95, of Order XXI, CPC 1908, order the delivery of the property to be made from person, classified as (1) to (4) above, the putting such purchaser or any person whom the purchase may appoint to receive delivery on his behalf in possession of the property. The court may also, if the need be, direct removal of the persons classified as (a) to (c) above, if they refuse to vacate the same.

The possession contemplated under Rule 95, Order XXI, CPC 1908, is actual possession.

The purchaser, on the strength of his sale certificate, entitled to get an order from the court for the delivery of the property to him by any person bound by the decree. This Rule does not contemplate any enquiry except that the court, before making an order, must satisfy itself that the person to be dispossessed belongs to one of the categories of persons set out in the Rule. This Rule has no application to the trespassers and accordingly proceedings to eject them must be not in execution but in a suit.

It may be observed that a purchaser at a court sale is not bound to apply for possession under this Rule, he may, at his option, bring a regular suit for possession. The remedies by way of application and by way of suit are concurrent.

The High Court of Madras has amended Rule 95, Order XXI, CPC 1908, to the effect that where the house of which the delivery is given, is found to be locked, the court shall order breaking open of lock and handing over of the delivery of possession to the purchaser.

Possession with the Tenant

Where however, the possession of the property is with the tenant, the delivery of the property is to be taken under Rule 96 of Order XXI, CPC 1908. In such circumstance, the possession contemplated is a symbolic possession, which should not be confused with paper possession. In a symbolic possession, there is real delivery of possession in the mode prescribed by Rule 96 and is as against the judgment-debtor as effective as actual delivery.

To take the possession from the occupancy of a tenant, it is necessary that the court on the application of the purchaser, shall order delivery to be made by affixing of a copy of certificate of sale in some conspicuous place on the property and by proclaiming to the occupants by the bet of drums or other customary mode that the interest of the judgment-debtor has been transferred to the purchaser. To take possession of the immovable property from the tenant, the principles of rule 36, Order XXI, CPC 1908, are also applicable.

Where a Rent Act is applicable, the inter se rights and obligations of the landlord and tenant are regulated and controlled by such Rent Act. In areas where any special law governing the incidences of tenancy is not applicable, the law relating to lesser and lessee as envisaged by the

general law of the land, namely, Transfer of Property Act, will regulate and determine inter se rights of landlord and tenant.

In dealing with the rights and obligations which a third party may have in respect of a property in which a receiver has been appointed, the receiver, like a party to the suit, will have same limitation. The receiver will be bound by the incidences of tenancy flowing from the statue regulating for eviction of the tenant can be passed by the court at the instance of its officer, the receiver without taking recourse to appropriate proceedings for eviction of the tenant under the appropriate statute regulating and governing the inter se rights of landlord and tenant.

The plea of tenancy rights is often adopted by the dishonest litigants to protect the possession of the immovable property. Often rent receipts, unregistered and unstamped lease deeds, rent attachment orders etc are produced before the court to substantiate their claim of tenancy rights. A vigilant creditor must lift the veil over documents filed by the court. They must appreciate that mere payment of rent does not bring about contractual tenancy.

A lease is created under section 107, of the Transfer of Property Act 1882, according to which a lease is made in either by oral tenancy accompanied by delivery of possession or a written lease deed. The lease deeds which have been reduced in writing requires registration of the same, however, section 18 of the Registration Act, creates certain categories of lease that do not require to be registered compulsorily.

Resistance or obstruction to Possession of Immovable Property

A purchaser of an immovable property sold in execution of a decree, may make an application under Rule 97, Order XXI, CPC 1908, to the court, if he is resisted or obstructed by any person is obtaining possession of the property. The application should give incidence of such resistance or obstruction in the application. The court on receipt of the application shall proceed to adjudicate upon the application in accordance with the provisions of Order XXI.

The court on receipt of the application, complaining of resistance shall adjudicate the application under Rule 98, Order XXI of CPC 1908, and may make either of the following orders:

(a) make an order directing applicant to be put in possession of the property;
(b) make an order dismissing the application; and
(c) pass such other order as in the circumstances of the case it may be fit.

Where, however, the court is satisfied that the resistance or obstruction was caused without any just cause by either of the following persons-

(a) The judgment-debtor
(b) Some persons at his instigation or on his behalf;
(c) By the transferee, where transfer was during the tendency of the suit or execution proceedings.

It shall direct the applicant to be put in possession of the property. If the resistance is continued by the above stated person, the court may also order the obstructionist to be detained in the civil prison for a term unto 30 days.

The Bombay High Court has amended Rule 98, Order XXI of CPC 1908, the effect of which is that compensation may also be paid by the persons responsible for resistance or obstruction to the decree-holder or purchaser. The reason for granting compensation is the delay and expenses caused by the decree-holder or purchaser in obtaining the possession.

It is only the purchaser at the court sale who can apply under this Rule, if any person in obtaining possession resists him. A purchaser of the property by a private treaty cannot apply under this rule. Hence, this Rule cannot be availed off when the property is not sold by the court in execution but transferred by the judgment-debtor to the decree-holder privately in satisfaction of the decree.

Recovery Through Section 138 of Negotiable Instrument Act, 1881

Many a time, civil proceedings for recovery of money do not bear fruitful results even through the creditor it relentlessly. However, the fear of imprisonment and criminal trial are sufficient to make the debtor realize the benefits of settlement with the creditor.

Section 138 of Negotiable Instrument Act, 1881, is employed as one the ways to pressurize the debtor to pay up without waiting for a decree to come through. The requirement of presence of the accused before the court on all dates of hearing is a factor that encourages the parties to settle the matter rather than pursue litigation. The remedy of section 138 is very effectively used against the persons who have limited exposure to litigation, however, where the accused has many pending litigations against him, it may not turn out to be very effective in short run. It is bound to succeed in the long run for sure.

The main object of the Negotiable Instrument Act, 1881, is to legalize the system by which, the instruments contemplated by it could be passed from hand to hand by negotiation like any other goods. The object of section 138 of Negotiable Instrument Act is to inculcate faith in the efficacy of banking operations and credibility in transacting business on negotiable instruments. Section 138 has been incorporated to prevent the drawer of negotiable instruments. From drawing a cheque that he knows or intends to be dishonored due to insufficient funds in his bank account and still induces the payer or holder to act on such representation.

The Negotiable Instrument Act, 1881, was amended by Banking, Public Financial Institutions and Negotiable Instruments Law (Amendment) Act, 1988 wherein a new chapter, Ch XVII, was inserted for the penalties in case of dishonor of cheques due to insufficiency of funds in the account of drawer of the cheque.

These provisions were incorporated with a view to encourage the culture of use of cheques and enhancing the credibility of the instruments.

The existing provisions in the Negotiable Instrument Act, 1881, namely section138-42 were found deficient in dealing with dishonor of cheques. Not only the punishment provided in the Act has been proved to be inadequate, also, the procedure prescribed for the courts to deal with such cases expeditiously in time bound manner in view of the procedure contained in the Act. Thus, it was decided to bring out, inter-alia the following amendments in the Act of 1881, by Amendment of 2002-

(1) To increase the punishment s prescribed under the Act from one year to two years;
(2) To increase the period for issue of notice by the payee to the drawer from 15 days to 30 days;
(3) To provide discretion to the court to waive the period of one month, which has been prescribed for taking cognizance of the case under the Act?

The Amendments in the Act are aimed at-

(1) Earlier disposal of cases relating to dishonor of cheque;
(2) Enhancing punishment to offenders;
(3) Introducing electronic image of a truncated cheque and a cheque in the electronics form and
(4) Exempting an official nominee director from prosecution under the Negotiable Instrument Act, 1881.

On careful analysis of section 138, it is seen that an offence is created when the bank returns cheque unpaid for any of the reasons mentioned therein and the same is returned by the bank with the endorsement like:

(1) 'Refer to the drawer'
(2) 'Instructions for stoppage of payment' and
(3) 'Exceeds arrangement'.

The significant fact, however, is that the proviso lays down three conditions precedent to the applicability of the above section which is as follows:

(a) Drawing of the cheque;
(b) Presentation of the cheque of the bank;
(c) Returning the cheque unpaid of the drawer bank;
(d) Giving notice in writing to the drawer of the cheque demanding payment of the cheque amount and
(e) Failure of drawer to make payment within 15 days of the receipt of the notice.

The preconditions for the applicability of section 238 of the Negotiable Instruments Act is that

(1) The cheque should have been issued for a 'debt or other liability'. The explanation to section 138 amplifies that for the purpose of the section; 'debt or other liability' means 'a legally enforceable debt or other liability'.
(2) The cheque is given for the discharge of debt in whole or in part or other liability.
(3) The cheque is returned by the bank.
(4) The same is returned by the bank with the endorsement like
    (i) 'refer to the drawer'
    (ii) 'instructions for stoppage of payment'
    (iii) 'exceeds arrangement'

If these conditions exist then it would amount to dishonor within the meaning of section 138 of the Negotiable Instruments Act.

The Supreme Court enhanced the scope of section 138 of Negotiable Instrument Act, by observing 'account closed' would mean that the cheque is returned as unpaid on the ground that 'the amount of money standing to the credit of that account is insufficient to honor the cheque', and thus proceedings under section 138 would be attracted.

If, however, a person draws a cheque with no sufficient funds available to his credit on the date of issue, but makes the arrangement or deposit the

amount thereafter, but before the cheque is put in the bank by the drawer, and the cheque is honored, in such a situation, presumption of dishonesty on the part of drawer under section 138 would not be justified.

For prosecuting a person for an offence under section 138 of the Negotiable Instruments Act, it is inevitable that the cheque is presented to the banker within a period of six months from the date on which it is drawn or within the period of its validity whichever is earlier.

When a post-dated cheque is written or drawn, it is only a bill of exchange and therefore the same remains a bill of exchange, and so the provisions of section 138 are not applicable to the said instrument.

The post-dated cheque becomes a 'cheque' within the meaning of section 138 of the Act on the date, which is written thereon. The date of cheque can however be changed.

There are no provisions in the Negotiable Instruments Act or in any other law, which stipulated that, a drawer if a negotiable instrument cannot revalidate it. It is always open to a drawer to voluntarily revalidate a negotiable instrument, including a cheque.

Section 3 of Negotiable Instruments Act, defines the 'banker' to include any person acting as a banker and any post office savings bank. 'The Bank' referred to in clause (a) to the proviso to section 138 of the Act, would mean the drawer bank on which the cheque is drawn and not all banks where the cheque is presented for collection including the bank of the payee, in whose favor the cheque is issued.

A combined reading of sections 3, 72 and 138 of the Act, leaves no doubt that the law mandates, the cheque to be presented to the bank on which it is drawn if the drawer is to be held liable. Such presentation is necessarily to be made within 6 months at the bank on which the cheque is drawn, whether presented personally, through another bank, namely the collecting bank of the payee.

The non-presentation of the cheque to the drawer bank within the period specified when the section would absolve the person issuing the cheque of his criminal liabilities under section 138 of the Act, who shall otherwise may be liable to pay the cheque amount to the payee in a civil action initiated under the law.

The position for attraction of section 138 will not be different even if the drawer has instructed the bank stop the payment prior to the presentation of the cheque for encashment. The Supreme Court has

held that in case, after the cheque is issued to the payee or to the holder in due course and before it is presented for encashment, notice is issued to him not to present the same for encashment and yet the payee or the holder in due course presents the cheque to the bank for payment and when it is returned on instructions, section 138 does not get attracted, does not fit in which the object and purpose of the provision which, is to promote the efficacy of banking operations and to ensure credibility in transacting business through cheques.

Acceptance of this proposition will make section 138 a dead letter. By giving instruction to the bank to stop payment immediately after issuing a cheque against a debt or liability, the drawer can easily get rid of the penal consequences notwithstanding the fact that a deemed offence was committed.

Once the cheque is issued by the drawer a presumption under section 139 must follow and merely because the drawer issues a notice to the drawer or the bank for stoppage of payment, it will not preclude an action under section 138 of the Act, by the drawer or the holder of a cheque in due course.

A cheque can be presented any number of times to the bank within the period of its validity. Clause (a) of the proviso to section 138 does not put any embargo upon the payee to successively present a cheque during the period of its validity.

This apart, in the course of business transaction it is not uncommon for a cheque being returned due to insufficient funds or similar such reasons and being presented again by the payee after sometime, on his own volition or at the request of the drawer, in expectation that it would be encased. The primary interest of the payee is to get his money and not prosecution of the drawer, recourse to which, normally, is taken out of compulsion and not choice.

On each presentation of cheque and its dishonor, a fresh right and not cause of action accrues in his favor. He may, therefore, go an presenting the cheque without taking pre-emptor action in exercise of his right under clause (b) of section 138, so as to enable him to exercise such right at any point of time during the validity of cheques. However, once he gives a notice under clause (b) of section 138, he forfeits such right for in case of failure of the drawer to pay the money within the stipulated time, he would be liable for offence and the cause of action for filing the complaint would arise.

To continue an offence under section 138 of the Act, the complainant is obliged to prove its ingredients, which include the receipt of notice, by the accused under clause (b).

It has to be kept to mind that it is not the 'giving' of the notice, which makes the offence, but it is the 'receipt' of the notice by the drawer, which gives the cause of action to the complainant to file the complaint within the statutory period. It is therefore; clear that 'giving notice' in the context is not the same as receipt of notice. Giving is a process by which receipt is the accomplishment. It is for the payee to perform the former process by sending the notice to the drawer at the correct address. The thrust in the clause (b) is on the need 'to make a demand'. Though no form of notice is prescribed in clause (b), the requirement is that the notice shall be given in writing.

It is well-settled that a notice refused to be accepted by the addressee can be presumed to have been served upon him. Nowhere in the Act is said that the notice under section 138 must be sent by registered post or it should be dispatched through a messenger. The notice may be sent also by fax.

The object is issuing notice indicating the fulcrum of dishonor of the cheque is to give the opportunity to the drawer to make the payment within the stipulated time, so that it will not necessary for the payee to proceed against the payer in any criminal action, even though the bank has dishonored the cheque.

Section 142 of Negotiable Instruments Act provides that the payee or the holder in due course of the said cheque can make a complaint under section 138.

The complainant has to be a corporeal person who is capable of making an appearance in the court. However the complaint has been made in the name of an incorporeal person like company or a corporation, it is necessary that a natural person must represent such a juristic person in the court. There may be occasions when different persons can represent the company on different dates of hearing.

Any one can set the criminal law in motion by filing a complaint of facts constituting an offence before a magistrate entitled to take cognizance. It has been held that no court can decline to take cognizance on the sole ground that the complainant was not competent to file the complaint.

Thus, even presuming, that initially there was no authority, still the company can, at any stage, rectify that defect. At a subsequent stage, the company can send a person who is competent to represent the

company. The company can rectify the defect of the authority of the person representing the company before the court at any stage.

It has been held that if any special statute prescribed offences and makes any special provision for taking cognizance of such offences under the statute, then the complainant requesting the magistrate to take cognizance of the offence must satisfy the eligibility criterion prescribed by the statue.

If the person committing an offence under section 138 is a company, every person who, at the time of offence was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the offence and shall be proceeded against the unshed accordingly.

However, where a person is nominated as a director of a company by virtue of his holding any office or employment in the Central Government or State Government or a financial corporation owned or controlled by Central Government or the State Government, as the case may be, then the shall not be liable for prosecution under Ch XVII of the Negotiable Instruments Act. This has been amended by the Amending Act of 220, which has relaxed the strict rules of section 141 of the Negotiable Instruments Act.

(I) **Complaint to be in Writing:**

A complaint under sc 138 has to be in writing, made by the payee or, as the case may, the holder in due course of the cheque.

(II) **Complaint within One Month from the Date of Receipt of Notice:**

The complaint is to be made within one month of the date on which the cause of action arises under clause (c) if the proviso to section 138. Clause (c) of section 138 requires that the cause of action would accrue in favor of the complainant only when the drawer of such cheque fails to make the payment of the amount of the said cheques within 15 days of receipt of said notice. For the purposes of limitation, the computation would be starting on day next to receipt of notice.

The cognizance of offence punishable under section 138 is made under section 142 of Negotiable Instruments Act.

The Amending Act of 2002 gives discretion to the court to waive the period of one month, which has been prescribed for taking cognizance of the case under the Act. A complaint may be entertained after the prescribed period if the court is satisfied that the complaining has

sufficient cause for not making a complaint within such period. The words 'sufficient cause' should receive a liberal construction so as to advance substantial justice.

A complaint under section 138 of Negotiable Instruments Act may be presented in local jurisdiction of the court, within which any of the following acts were done:

(1) Drawing of the cheque;
(2) Presentation of the cheque to the bank;
(3) Returning the cheque unpaid of the drawer bank;
(4) Giving notice in writing to the drawer of the cheque demanding payment of the cheque amount;
(5) Failure of drawer to make payment within 15 days of receipt of notice.

As stated, these five acts are necessary to constitute an offence of section138. It is not necessary that all the above five acts should have been perpetrated at the same place. It is possible that each of those five acts could be done at fie different places. However, a concatenation of all the above five is a sine qua non for the completion of the offence under section 138.

In view of section 178 (d) of Criminal Procedure Code, it is clear any of the five different courts exercising jurisdiction in one of the five local areas can become the place of trial for the offence under section 138 of the Act. The complainant can choose any of those courts having jurisdiction over any one of the local area within the territorial limits of which any one of those five acts was done.

Section 22 of Sick Industrial Companies (Special Provisions) Act 1985 (herein after referred to as 'the section') does not create any legal impediment for instituting the proceeding with a criminal case on the allegations of an offence under section 138, Negotiable Instruments Act against the company or its directors. The sc only creates an embargo against disposal of assets of the company for recovery of its debts. The purpose of such embargo is to preserve the assets of the company from being attached or sold for realization of dues of the creditors. The section does not bar payment of money by the company or its directors to other persons for satisfaction of their legally enforceable dues.

Section 138 of the Negotiable Instruments Act is a penal provision, the commission of which offence entails a conviction and sentence of proof of the guilt in duly conducted criminal proceedings.

Once the offence under section 138 id completed, the prosecution proceedings can be initiated not for recovery of the amount covered by the cheque but for bringing the offender to penal liability. It must therefore, be held that if commission of the offence under section 138 of the Act was completed before the commencement of proceedings under section 22 (1) of Sick Industries Companies Act, there is no hurdle in any of the provisions of sick Industrial Companies Act against the maintainability and prosecution of criminal complaint duly instituted under section 142 of the Negotiable Instruments Act.

There is no provision under the Companies Act, 1956, which prohibits enforcement of a debt due from a company.

When a company goes into liquidation, enforcement of debt due from the company is only made subject to the conditions prescribed therein. However, that does not mean that the debt as become unenforceable all together. Perhaps due to want of sufficient assets of the company, the realization of the debt would be difficult but that is no premise to hold that the debt is legally unenforceable. Enforceability of a debt is not be tested on touchstone of the modality or the procedure provided for its realization or recovery.

Complaint under section 138 of the Negotiable Instruments Act can be quashed under section 482 of the Code of Criminal Procedure.

However, jurisdiction under section482 of the Code has to be exercised with great care.

In the exercise of its jurisdiction, the High Court is not to examine the matter superficially. It is to be seen if a matter, which is essentially of a civil nature, has been given a cloak of criminal offence. Criminal proceedings are not a short cut of other remedies available in law. Before issuing processes a criminal court has to exercise a great deal of caution. For the accused, it is a serious matter. The jurisdiction under this section has to be exercised to prevent abuse of the process of any court or otherwise to secure the ends of justice.

➢ Out of Court Settlement

1. GENESIS:

With the stabilization of Income Recognition, Asset classification and provisioning norms, banks are becoming increasingly sensitive to credit risk and there is growing awareness to contain Non-Performing Assets (NPAs) at a low level, as these greatly affect

banks profitability due to non-recognition of interest income and provisioning requirements.

Past experience has been that neither the conventional means of recovery nor even a reasonable well drawn Recovery Policy has yielded the desired results. Legal remedies presently available to the banks are expensive and time consuming. There is hence, urgency for adopting a new and pragmatic approach to step up recovery of NPAs.

From time to time, RBI has been issuing guidelines to be followed by the Banks while entering into compromise / negotiated settlement with the borrowers or considering waiver / write off of dues. Banks are required to have a "Loan Recovery Policy" which sets down the manner of recovery of dues, factors to be taken into account before considering waiver, norms for permitting sacrifice / waiver, decision levels, reporting to higher authorities and monitoring write off/ waiver cases.

Reserve Bank of India had set up a Working Group for evolving uniform guidelines on write off/ compromise settlement. The Governor, Reserve bank of India while announcing Monetary and Credit Policy for the year 1999-2000 on 20.04.1999, had also mentioned that Government has directed Public Sector Banks to set up Settlement Advisory Committees so that chronic cases especially those relating to the small Sector are settled in a timely and speedy manner.

Reserve Bank of India, vide latter dated 27.5.1999, issued guideline regarding constitution of settlement Advisory Committees for settlement of cases of small sector.

Reserve Bank of India vide their letter no. BP BC 11/21.01.40 / 99-00 dated 27th July 2000, modified the guidelines issued earlier vide their letter dated 25.5.1999. Revised guidelines now cover NPAs upto Rs.5 crore relating to all sectors, including the small sector. These guidelines are non discretionary and non discriminatory which will be uniformly implemented by all Public Sector Banks. Special guidelines will remain operative only upto 30.6.2001.

RBI vide aforesaid letter dated 27.07.2000 has also advised that the Board of Directors of banks may evolve policy guidelines regarding one time settlement of NPAs over Rs 5 crore covering the computation formula, realizable amount, cut off date and payment conditions with reference to factor of security and disposability,

etc, as part of its loan recovery policy including setting up of settlement advisory Committee, staff accountability and other relevant aspects and decide individual cases in accordance with such policy.

2. <u>OBJECTIVE:</u>

In respect of funds blocked up in NPAs. Bank has to –

a) maintain capital at the prescribed level to comply with adequacy norms.
b) Continue incurring cost to service the funds blocked in NPAs and
c) Bear the cost for loss of opportunity to lend these funds at favorable rates, if NPAs, are not reduced.

It is, therefore, imperative that the pace of reduction of NPAs be stepped up as per the prevent policy / practice in the system and one way to achieve it is entering into compromise / negotiated settlement with the Borrowers out of courts. This is one of the speedy ways of recovery of dues by which blocked funds may be made available for:

i. Recycling at favorable rates and earning profits;
ii. Reducing capital adequacy requirements; and
iii. Saving the cost of funds so blocked up as NPAs.

NPAs can be prevented / reduced through persuasion by way of compromise / negotiated settlements with the borrowers / guarantors or by resorting to legal proceedings. Legal action is a long drawn costly procedure and our intention should be not to waste good money after bad money. Our past experience of recovery of bank dues through legal actions has not been very encouraging and cost effective.

From cost benefit angle, approval of a settlement / compromise offer would be considered beneficial to the interest of the bank if the following criteria (all or major part of the same) are satisfied

i. A critical NPA would be realized.

ii. The amount to be realized would enable the bank to credit a part of it to its income account and would result release of provision.

iii. Bank would earn future interest on the compromise/ negotiated settlement amount till it is actually paid.

iv. All loan assets generally being 100% risk weighted, as a result of compromise settlement. Realization of the NPAs would facilitate improvement of bank's capital adequacy.

v. Compromise / settlement would result in saving of time & cost of the bank in suit filed / decreed accounts.

vi. Amount realized would be available for recycling and profitable use and will give opportunity to earn income at current rates of interest.

It should therefore be our endeavor to recover maximum possible dues through compromise route. However, it has to be ensured that the compromise / settlement decision are taken judiciously and in the best interest of the bank. The compromise should be a negotiated settlement under which the bank should ensure to recover its dues to the maximum extent possible at minimum expenses, in the shortest possible period.

Proper distinction needs to be made between willful defaulters and the borrowers defaulting in repayments due to the circumstance beyond their control.

Where security is available for assessing the realizable value, proper weight age has to be given to the location / condition and marketable title and possession thereof. What is Important in settlement cases is that the bank could promptly recycle the funds with Advantage instead of resorting to expensive recovery proceedings spread over a long period.

3. Factors to be Taken in to Account While Considering Compromise / Negotiated Settlement:

a) Genuineness of the case and difficulties of the borrowers and his / their readiness to enter into compromise to enter into compromise for repayment of the dues.

b) Age and status of the Advance outstanding in the account.

c) Death of the borrowers / partners / guarantors during the course of the accounts with the Bank materially affecting the affairs of the borrowers.

d) Availability of primary and / or collateral securities and / or other attachable securities of the borrowers / partners / guarantors and reliability thereof in due time without any lengthy / costly court proceedings at the expenses of the Bank;

e) Realistic Realizable value of the primary and / or collateral Securities and other attachable securities and whether it covers the dues to be recovered by the bank.

f) Present business activities of the borrowers / partners / and guarantors and source of funds for compromise / negotiated settlement;

g) Advisability for compromise / negotiated settlement without recourse to legal process as it involves delay, cost and further increase in the dues to the Bank owing to addition of interest and other charges over a period of time;

h) Assessment of the chance and extent of recovery for the Bank, if recovery of the dues has to be achieved through Court Proceeding;

i) Possibility for the bank, even in suit filed accounts, to explore the chance of compromise / negotiated settlement without pursuing suits any further;

j) Possibility for the bank even in decreed accounts to explore, if compromise / negotiated settlement would be advisable if (i) there are no assets available , (ii) available assets may not fetch more than the compromise offer, (iii) there would be complications in executing the decree and realize the dues in a short time at minimum expense.

k) Sometime, after an account has turned NPA or after filing suit or obtaining decree, another party comes forward to purchase the Unit / business interest of the Debtors, Bank can consider compromise / negotiated settlement with the third party with or without the consent of the borrowers / partners / guarantors.

Norms Do Epwemirrinef Sacrifice / Waiver:

It should be the endeavor at all levels to recover maximum possible dues through compromise route. It is, however, to be ensured that recommendation for compromise are made and compromise decision taking judiciously and in the best interest of the bank.

Approach for considering waiver / sacrifice /loss on compromise can be in the following order based on merits and attendant circumstance of each individual case.

a) Waiver of penal interest only with or without compounding effect.

b) Waiver of effect of compounding of interest, if it facilitates recovery of dues fully by application of Interest in the account at documented rate on simple basis from the date say:
   i) of filing suit in the account against the borrower/guarantors OR
   ii) of transfer of dues to the protested Advances category OR
   iii) account became NPA, OR
   iv) the Unit was affected by some natural calamities and / or other external factors, beyond the control of the borrowers / guarantors OR
   v) of death of the borrower / main partner / guarantor, during the period of loan materially affecting the affairs of the Party OR
   vi) the closure of the unit /strike / lockout / Government. policy / Court order OR
   vii) the unit stated incurring cash losses.

c) Waiver of a part or whole of simple interest can also be considered. In such an event, the Bank would recover the dues as on the cut-off date in full plus a part of interest at documented rate on simple basis, if part waiver is considered.

d) In exceptional cases, waiver of part of principal dues outstanding in the Bank's books can also be considered wherever it is so justified on, merits by the facts / circumstances in each case.

e) The concept of compromise should be treated as an extension of the concept of Net Present Value / Discounted Cash Flow. Therefore, the opportunity cost of funds in hand vis-à-vis that of funds which could be in hand at a later period should be kept in view while considering the compromise proposal.

f) In case where compromise / negotiated settlements are to be entered into under the aegis of BIFR/AAIFR, Bank will normally adhere to the direction / decision of such authorities.

➢ **Recent Developments:**

"The concern of the auditor is with the overall adequacy of provisions in respect of each of the heads under which advances are required to be shown in the balance sheet of a bank. Thus, for example, the auditors will have to examine the adequacy of the overall provisions made by the bank separately in respect of (a) bills purchased and discounted, (b) cash credit, overdrafts and loans repayable on demand and (c) terms loans. Similarly, the auditors should examine the overall adequacy of the provisions under each of the other heads of advances in the balance sheet. If, in his opinion, the overall provision made by the bank in respect of any of the heads is inadequate, he should make a suitable qualification in his report".

Vide Reserve Bank of India Circular No: DOS.CO.BC.21/11/02/823/96-97 dated 31st October, 1996 about assessments relating to asset valuation and loan loss provisioning it is stated that "in the case of inspection of banks by Reserve Bank of India, it has been observed there have been divergence between the asset classification/evaluation made by banks/statutory auditors and the assessment made by Reserve Bank of India inspectors. Such divergence arises mainly due to non-adherence

to the aforesaid guidelines and ignoring certain qualitative factors like realizable value of security becoming suspect or unrecoverable having a bearing on the values of risk assets. In order to narrow down the divergence and ensure adequate provisioning by banks, it is suggested that the bank's Statutory auditors, if they so desire, could have a dialogue with RBIs Regional Office/inspectors who carried out the inspection during the previous year with regard to accounts contributing to the difference.

Further, as per another circular bearing no: BP.1576/21-04-018/96 dated 18th December 1998 Reserve Bank of India stated that "It has been brought to our notice that the quantum of non performing assets is often assessed differently by the Statutory Auditors of banks due to varying interpretations of the Prudential Norms for Income Recognition, Asset Classification etc.

With a view to adopting a more uniform approach in this regard and providing clarifications, where necessary, Chief General Manager, Department of Banking Operations and Development, Central Office, Reserve Bank of India, Mumbai has been appointed as "Nodal Office" to clarify doubts on interpretation of the Prudential Norms for Income Recognition, Asset Classification, Provisioning and Capital Adequacy. The Statutory Auditors of the banks, if they so desire, could also have dialogue with the Reserve Bank of India inspectors who carried out the bank's inspection for the previous year and also with the "Nodal Officer" on matters relating to Income Recognition/Asset Classification etc., so that there is uniformity in the accounting standards adopted by banks".

Reserve Bank of India Circular No. Co.BP.BC.6/11.01.005/96-97 dated 15th May 1997 touch upon the independence of Statutory Auditors. Para 2 of the circular states as follows: "In this connection, we wish to clarify that the primary responsibility for making adequate provisions for any diminution in the value of the loan assets, investments or other assets is that of the bank management and the statutory auditors and the assessment made by the inspecting officers of Reserve Bank of India is furnished essentially to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of the prudential guidelines issued to banks".

The various Reserve Bank of India norms on Income Recognition, Asset Classification and Provisioning have been arranged in this thesis in proper sequence as a ready beckoner so that it may help the auditors and bank managers in understanding the subject easily an din ensuring compliance with the norms without resorting to reading and

understanding the various circulars of Reserve Bank of India. An easy method for identifying NPAS in situations where interest is charged separately or interest is loaded with installment is highlighted and a few worked out examples are also given. All Reserve Bank of India circulars on the subject are also furnished separately.

The Reserve Bank reiterates that banks and financial institutions should adhere to the Prudential Norms on Asset Classification and provisions correctly and avoid the practice of "evergreening". The banks are advised to take effective steps for reduction of NPAs and also put in place risk management system and practices to prevent re-emergence of fresh Non Performing Assets. The banks are further advised to put in place formal assets/liability management systems with effect from April 1st, 1999. Banks have also been advised to ensure a loan review mechanism for larger advances soon after its sanction and continuously monitor the weakness developing in the accounts for initiating corrective measures in time. Reserve Bank of India has issued guidelines for recovery of dues relating to non performing assets of Public Sector Banks.

CHAPTER – VI

DEBT RECOVERY LAWS

CHAPTER VI

DEBT RECOVERY LAWS

➢ Background of the Debt Recovery Tribunal

The existing procedure for recovery of debts due to the banks and financial institutions had blocked a significant portion of their funds in unproductive assets and therefore the value of it deteriorated with the efflux of time. Therefore an urgent need was felt to work out a suitable mechanism through which the dues to the banks and financial institutions could be realized without delay. In 1981 a Committee was constituted under the Chairmanship of Shri. T.Tiwari and that had examined the legal and other difficulties faced by banks and financial institutions and suggested remedial measures including changes in law. The Tiwari Committee had also suggested setting up of Special Tribunals for recovery of dues of the banks and financial institutions by following a summary procedure. It was observed by the Committee that setting of these Special Tribunals will fulfill a long-felt need and also will be an important step in the implementation of the Report of Narasimham Committee. As per reported statistics as on 30th September, 1990 more than fifteen lakhs of cases filed by the Public Sector Banks and about 304 cases filed by the financial institutions were pending in various Courts. Recovery of debts involved more than Rs.5622 crores in dues of Public Sector Banks and about Rs.391 crores of dues of the Financial Institutions. As per latest information available in the year 2004 amount of Rs.74, 000 crores were due to the Public Sector Banks and Financial Institutions. As per recent report during the year 2004 total amount due to Public Sector Banks and Financial Institutions is Rs. 1, 20,000 crores. The locking up of public money of huge amount prevents proper utilization and re-cycling of the funds for the development of the country.[1]

➢ Establishment of Debt Recovery Tribunals

With this end in view of Recovery of Debt Due to Banks and Financial Institutions Act was placed on the statute book on 27th August 1993 to provide for the establishment of Tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions and for matters connected therewith or incidental thereto. This Act was enforced with effect from 24th June 1993.

Applicability and scope of the Legislation

1. The Act extends to whole of India except the State of Jammu and Kashmir. Provisions of the Act shall not be applicable where the amount of debt due to any banks and financial institutions or to a consortium of banks is less than ten lakhs or such other amount being not less than one lackh rupees as may be specified by the Central Government by official notification. By the Recovery of Debts Due to Banks and Financial Institutions (Amendment) Act, 2000 the original Act was further amended in order to ensure expeditious adjudication and recovery of dues of banks and financial institutions and to remove legal anomalies and strengthen the Recovery Tribunals. For the effective implementation of the Act the Central Government has framed the Debt Recovery Tribunal (Procedure) Rules, 1993, the Debt Recovery Appellate Tribunal (Procedure) Rules, 1994 and many other rules.

2. The Act is divided into six chapters of which Chapter – I deal with preliminary concepts and definitions of certain terms used in the Act, Chapter – II of the Act consist of Sections 3 to 16, which provides for establishment of Tribunal and Appellate Tribunal. Chapter – III of the Act relates to jurisdiction, powers and authority of Tribunals. Chapter – IV deals with procedure of Tribunals whereas Chapter – V relates to recovery of debts determined by Tribunals. And the last Chapter – VI being miscellaneous which deals with transfer of pending cases to Tribunal.

3. Section 18 of Chapter III bars the jurisdiction of other Courts except the Supreme Court and High Courts exercising jurisdiction under Arts. 226 and 227 of the constitution.

➢ <u>Definition of Debt</u>

Section 2(g) of the Act defines the term Debt as "Debt means any liability (inclusive of interest) which is claimed as due from any person by a bank or a financial institutions or by a consortium of banks or financial institutions during the course of any business activity undertaken by the bank or the financial institutions or the consortium under any law for the time being in force, in cash, or otherwise, whether secured or unsecured, or assigned, or whether payable under a decree or order of any Civil Court or any arbitration award or otherwise or under a mortgage and subsisting on, and legally recoverable on, the date of application." Any liability or money due from a person or by a bank or a financial institutions or a banking company to another bank or a

financial institutions or banking company during the course of any business activity undertaken will constitute a debt. Where an employee of the company emits any fraud and misappropriates the money, it should not be constituted as a debt due.[2] Bank of India vs. Vijay Ramnikal Kapadia, AIR, and 1997 Guj.75 at. P.76; Assam Leather Industry vs. Union of India (2001) 104 Com. Cases 115 at p. 145 (Gau.) The expression Debt is having wide amplitude and includes any liability which is alleged as due from any person or by a bank during the course of any business activity undertaken by the Bank either in cash or otherwise. Such liability may be secured or unsecured, whether payable under a decree or order of any Court or otherwise and legally recoverable on the date of the application. In the case of United Bank of India vs. Debt Recovery Tribunal.[3] (AIR 1999 SC 1381 at p. 1385;) and in the case of J.U. Mansukhani & Company vs. Presiding Officer.[4] (AIR 2000 Delhi 103 at p.106) it was held that where a question arises whether any particular claim of any bank or financial Institutions. would come within the purview of the Tribunal created under the Act, then in such cases it is imperative to look into the whole averments made by the Plaintiff in the plaint and the claim in question made by the plaintiff has to be essentially one for recovery of a debt due to it from the defendants, and therefore the Tribunal which has the exclusive jurisdiction to decide the dispute and not the ordinary Civil Court.

➢ **Composition and powers of Tribunals**

A DRT shall consist of a person appointed by central Government as the Persuading Officer who shall be a person qualified to be or has been a District Judge. The Appoint is for a time of five years or until he attends the age of 62 whichever is earlier. Every appellate Tribunal Shall consist of one person appointed by The Central Government as the chair person for shall be qualified to be a Judge of High Court or a member of Indian Legal Service and the has healed a post in grade 1 for periods three years The appointment is for a period of five years or until the age of 65 whichever is earlier

As per Section 17 of the RDDBFI Act, 1993. The Tribunal shall exercise, on and from the appointed day, the jurisdiction, powers and financial institutions for recovery of debts due to such banks and financial Institutions.

An Appellate Tribunal shall exercise, on and from the appointed day, the jurisdiction, powers and authority to entertain appeals against any order made, or deemed to have been made, by a Tribunal under this Act,

➢ Procedure followed by Tribunal

1. Where a bank or financial institutions has to recover any debt from any person, it may make an application to the Tribunal within the local limits of whose jurisdiction-

    a) the defendant or each of the defendants where there are more than one, at the time of making the application, actually and voluntarily resides, or carries on business, or personally works for gain; or
    b) any of the defendants where there is more than one, at the time of making the application, actually and voluntarily resides, or carries on business, or personally works for gain; or the cause of action, wholly or in part, arises.

2. Application to be filed should be in prescribed format and the necessary documents should be enclosed therewith and prescribed fees are also required to be paid along with the application. As per the Act Rs.12000 is fee payable for a claim o fRs.10 lakhs; if the claim is more than Rs.10 lakhs in that case Rs.1000 has to be paid for next Rs.1 lakh in addition to Rs.12,000. Maximum fees payable is Rs.1, 50,000. In case of an application for review for the orders passed by Debt Recovery Tribunal, 50% of the fees paid for filing of Original Application have to be paid. Application for interim orders prescribed fee is Rs.10. For filing of Vakalatnama, Rs.5 is the fee. The fee has to be paid by way of DD or IPO in the name of Registrar Debt Recovery Tribunal.

3. After filing the application, the Tribunal shall issue summons within 30 days to the defendant, thereby calling them to show because why the relief sought for by the Applicant should not be granted. The Defendant/s should file/present their written statement of defense at or before the first hearing or within such time as the Tribunal may permit, Debt Recovery Tribunal has powers and jurisdiction to entertain counterclaims. After hearing both the parties ie, Applicant/s and the Defendant/s the Tribunal shall pass such order as it thinks fit to meet the ends of justice. The Tribunal may make an interim order in the nature of injunction or stay or attachment against the defendant or retain him from transferring, alienating or otherwise dealing with, or disposing of, any property and assets belonging to him without the prior permissions of the Tribunal. Copy of every order passed by the Tribunal is to be served on the parties.[6]

The Tribunal can pass following interim order:

a) defendants to furnish security or;
b) to produce and place in the custody or at disposal of the tribunal property or value of the suit; or
c) appoint receiver or commissioner

In addition to this the Tribunal can attach the property of the Defendant/s. In the event of disobedience of the orders of the Tribunal, interim orders can be passed by the Tribunal for:

Sale of property of the person found guilty. In such cases the Tribunal can also order detention of the disobedient person in the civil prison. It can also remove from suit property any person in possession of than suit property.

It is provided in the act:

1) The Tribunal shall endeavor to dispose off the applications as expeditiously as possible and in any case within one hundred and eighty days from the date of application.[7]
2) The procedure and the powers of the Tribunal and Appellate Tribunal, are enshrined in Section 22 of the Act, which are as follows:
    a) summoning and enforcing the attendance of any person and examining him on oath;
    b) requiring the discovery and production of documents;
    c) receiving evidence on affidavits;
    d) issuing commissions for the examination of witnesses or documents;
    e) reviewing its decisions;
    f) dismissing an application for default or deciding it ex -parte;
    g) setting aside any order of dismissal of any application for default or any order passed by it ex-parte.
    h) Any other matter, which may be prescribed.

➢ Appellate Tribunal

The Aggrieved party shall make an appeal within 45 days from the date of the order to the Appellate Tribunal. No appeal shall lie against the order, which is passed with the consent of the parties. As per Section 21 if an appeal is filed by the Defendant, then the same cannot be entertained unless 75% of the amount of the debt, as has been

determined by the Tribunal is deposited at the time of tiling of the Appeal. The Appellate Tribunal may waive or reduce the amount to be deposited at its discretion. Powers to condone delay in filing of appeal are given to Tribunal. The Act or the Rules are silent in respect of filing of Caveat Application.

Some important cases:

I) Facts : The Banks in a single application to the Debt Recovery Tribunal under section19 of the RECOVERY of Debts due to Banks and Financial Institutions Act, 1993, sought recovery of a total sum exceeding Rs.10 lakhs. The petitioner in a writ petition contended that the bank could not have filed a single application in regard to two separate causes of action and that the relief's sought by the bank were not consequential to one another; that the amount claimed in respect of each of the two accounts was less than Rs.10 lakhs and but for the fact that a single application was filed by clubbing the two claims, the Debt Recovery Tribunal would not have jurisdiction to try the original application.

Held that though there were two separate loan accounts and separate causes of action but the relief asked for is same. Therefore Bank must sue on all loans by single action. Total sum recoverable is exceeding Rs.10 lakhs though sum due on each loan is less than Rs.10 lakhs. Single Application to Tribunal is maintainable.

- Smt. Gerty Suvarna and Another Vs Union of India and Others 1998 (92) Company cases p. 782. This dictum was further followed in.
- R.S. Senthamarai Kannan and Another vs. Debt Recovery Tribunal and Others.[9] (2001 (103) company cases p.312)
- Lakshman Balaraman vs. Punjab National Bank.[10] (2000 (102) Company cases p.33)

In Allahabad Bank vs. Radha Krishna ----- & Others.[11] (1999 (6) SCC p.755,) it was held that Debt Recovery Tribunal while passing an order of injunction or stay should see that the principles of Natural Justice has been observed.

In the case of Allahabad Bank vs. Canara Bank & Others.[12] (2000) Company cases p.64 SC,) it was held that the Debt Recovery Tribunal has independent jurisdiction. Even though winding up proceedings against a company are pending before a Company Court, there is no

need to take leave of the company court to proceed with claims to banks or financial institutions against such company before Debt Recovery Tribunal.

In Union of India and Another vs. Delhi High Court Bar Association (2002 (4) SCC p. 275) constitutional validity of the Act has been upheld.[13]

➢ Mode of Recovery by Tribunal

Just like the civil court executes its decree the recovery certificate issued by the Debt Recovery Tribunal is executed by the designated Recovery Officers of the Debt Recovery Tribunal. As per second and third schedules of Income Tax rules

Rule 10 of Second Schedule of Income Tax Act 1961, states that all such property exempted from attachment and sale in execution of a decree of a civil court shall be exempt from attachment and sale under this schedule, hence the list of properties exempt form attachment under section 60 of Code of Civil Procedure 1908, shall also be applicable to certificate issued by the Debt Recovery Tribunal.

Rule 58 of Order XXI and section 47, CPC 1908, and Rule 11, Second Schedule of Income Tax Act, 1961 provides for procedure to challenge the attachment of property in respect of proceedings before the civil court and Debt Recovery Tribunal respectively.

➢ Debt Recovery Tribunal Proceedings and Recovery Certificate

The objection or claim to the recovery certificate passed by the Debt Recovery Tribunal is to be made to the designed Recovery Officer under rule 11 of Second Schedule of Income Tax Act 1961. The available ground of challenge is that the property is not liable to such attachment or sale.

The recovery officer on receipt of such objection shall proceed to investigate the claim or objection, however, no investigation shall be carried out, where the recovery officer, is of the opinion that the claim or objection are designedly or unnecessarily delayed.

On receipt of the objection or claim, the recovery officer may postpone the sale, where the property under objection is advertised for sale on such terms as to security or otherwise as the recovery officer may deem fit.

The objection or claim to the attachment of the property shall be disallowed in the following circumstances when the recovery officer is satisfied that;

(1) The property is in possession of defaulter as his own property
(2) The possession of the property is with some other person in trust for the defaulter.
(3) The possession of the property is with the tenant paying rent to the defaulter.

If the claim or objection is disallowed, the order of attachment survives and necessary consequences of sale would follow, which have been discussed herein below.

The recovery officer shall partly or wholly release the property from attachment if it is satisfied with the following circumstance:

(1) The property is not in possession of the defaulter; and / or
(2) The property is not in possession of any person holding in the same in trust for the defaulter; or
(3) The property is not in possession of a tenant or any person paying rent to the defaulter; or
(4) The property though in possession of defaulter, is not in his own right but in trust for some other person.

- **Sale of Attached Property**

Attachment of the immovable property of the defaulter shall be made by an order prohibiting the defaulter from transferring or charging the property in any way and prohibiting all persons from taking benefit under such transfer or charge. Attachment of Immovable Property in Debt Recovery Tribunal Proceedings

Rule 48, of the Second Schedule of Income Tax Act 1961, provides for the manner in which an immovable property can be attached in satisfaction of a recovery certificate. It is stated that the immovable property of the certificate debtor may be attached by passing an order prohibiting the defaulter/judgment-debtor from transferring or charging the pro in any way and prohibiting all persons from taking any benefit under such transfer or charge.

Unlike the Code of Civil Procedure, 1908, a copy of the order of attachment is also required to be served upon the judgment-debtor.

Rule 50, Second Schedule, of Income Tax Act, 1961 states that besides the service upon the judgment-debtor, the order of attachment shall also

be proclaimed at some place on or adjacent to the property attached by beat of drum or other customary mode. Further the copy of the order shall also be affixed on a conspicuous part of the property and on the notice board of the office of the recovery officer, who has attached the property.

The recovery officer, who is appointed to recover the dues under the recovery certificate issued by the Debt Recovery Tribunal, may also proceed to take steps for sale of the property attached, consequent to the dismissal of objection under rule 11 of Second Schedule, to the Income Tax Act 1961.

Rule 52 of Second Schedule to the Income Tax Act 1961, provides that the tax recovery officer may direct that the whole of the immovable property attached, be sold or such portion of the attached property thereof may be sold as may seem necessary to satisfy the certificate.

Rule 52, Second Schedule Income Tax Act 1961, states that the tax recovery officer may direct that the whole of the immovable property, which has been attached, or any portion of the attached property may be sold, which may seem necessary to satisfy the certificate. Further, where an immovable property is ordered to be sold, the tax recovery officer shall cause a proclamation of the intended sale to be made in the language of the district.[14]

The proclamation of the sale of immovable Property shall be drawn up after notice of the defaulter. The notice shall also state the time and place of sale of the attached immovable property. The contents of the proclamation are specified in Rule 53, Second Schedule, and Income Tax Act 1961, which includes the following details:

(1) The description of the property to be sold;
(2) The revenue, if any, assessed upon the property or any part thereof;
(3) The amount for the recovery, of which the sale is order;
(4) The reserve price, if any, below which the property may not be sold; and
(5) Any other thing, which the tax recovery officer considers it material for a purchaser to know, in order to judge the nature and value of the property.

The mode of making of proclamation of the sale is stated in Rule 54, of Second Schedule, Income Tax Act 1961. It is provided that the sale shall be made at some place of the attached property or near such attached property. The proclamation shall be done by beat of drums or other customary mode. The copy of the proclamation shall be affixed on a

conspicuous part of the attached property and on the conspicuous part of the office of the tax recovery officer. If the recovery officer directs, the proclamation shall also be published in the Official Gazette or in a local newspaper.

Where the property is divided into lots for the purpose of being sold separately, it shall not be necessary to make a separate proclamation for each lot. However, if the recovery officer is of the view that proper notice of the sale cannot be given by a single proclamation in case of sale by lots, it may be necessary for carrying out separate proclamation for each lot.

Rule 56, Second Schedule Income Tax Act 1961, provide that the sale shall be made by the public auction to the highest bidder and shall be subject to confirmation by the tax recovery officer. However, if the highest bidder bids less than the reserve price, no sale shall be made.

Rule 52, Second Schedule, Income Tax Act 1961, provides that the tax recovery officer may direct that any immovable property, which has been attached, or such portion thereof as may seem necessary to satisfy the certificate shall be sold. A proclamation of the intended sale is also required to be made in the language of the district where the sale has to take place. The sale shall be by a public auction to the highest bidder but it shall be subject to confirmation by the tax recovery officer.

Rule 55, Second Schedule, Income Tax Act 1961, states that no sale of immovable property shall take place without the consent in writing of the defaulter. The sale shall also not take place until after the expiration of at least 30 days from the date on which a copy of proclamation has been affixed on the property liable to be sold or in the office of the tax recovery officer.

(ii) Adjournment or Stoppage of Sale

The sale of immovable property may be postponed under rule 66, Second Schedule, Income Tax Act 1961, on an application of the defaulter. The defaulter has to satisfy the tax recovery officer that he may be able to raise the amount stated in the recovery certificate by the mortgage or lease or private sale of the property liable to be sold. The sale may also be postponed if the defaulter is able to show that he has another immovable property, which may be mortgaged, leased or sold to satisfy the certificate amount. The Tax Recovery Officer may on satisfaction of the above stated facts may postpone the sale on such terms and for such period as he thinks proper to enable him to raise the amount.

The sale shall be postponed subject to a condition that all monies payable under such mortgage, lease or sale shall be paid to the tax recovery officer and not to the defaulter.

Unlike the Code of Civil Providence 1908, there is no restriction on any person or class of persons to participate in the bid for or purchase of property sold in execution of recovery certificate. On the contrary, rule 59, Second Schedule Income Tax Act, 1961, authorize the assessing officer, on being authorized by the chief commissioner or commissioner to bid in for the sale of the property on behalf of the Central Government. The bid of the assessing officer is subject to the fact that the property, when put up for sale earlier, was postponed due to the reason that it attracted the price less than the reserve price fixed.

The other bidders who are bidding at the sale of the property are required to declare, if they are bidding on their own behalf or on behalf of their principals. Incase, the bidders are bidding for the principals, they are required to deposit their authority to bid, failing which, the bid shall be rejected.

The highest bidder shall be declared to be the purchaser in the public auction, subject only to confirmation by the recovery officer. The purchaser of the immovable property so declared is required under Rule 57, Second Schedule Income Tax Act 1961, to deposit immediately a sum equivalent to 25% of amount of purchase money to the officer conducting the sale. This deposit must happen immediately after his being declared as the purchaser by the recovery officer. In the event of purchaser failing to deposit a sum equivalent to 25% of the purchase money, the property shall forthwith be resold.

The balance sum due on account of purchase money is to be paid by the purchaser to the tax recovery officer on or before the 15^{th} day from the date of the sale of the property. If the purchaser fails to deposit the balance amount within the stipulated 15 days time from the date of sale, the deposit may be forfeited by the government and the property shall be resold. The defaulting purchaser shall also forfeit all his claim to the property or to any part of the sum for which it may subsequently be sold.

Where, however, the sale of an immovable property is set aside for the reasons, which are discussed here in below, the purchaser shall be entitled to refund of any money paid or deposited by him on account of purchase of the immovable property. The purchaser shall also be entitled to the penalty, if any, imposed by the tax recovery officer, for payment to the purchaser. The tax recovery officer may also permit interest to be paid to the purchaser on the amount deposited by him with the tax recovery officer.

Like the provisions under the Code of Civil Procedure 1908, the sale of an immovable property in execution of a decree may be set aside one following three grounds-

(a) Setting aside of sale on deposit of money;
(b) Setting aside of sale on ground of non-service of notice or irregularly; and
(c) Setting aside of sale, where defaulter has no saleable interest.

Each of the above grounds for setting aside the sale, are discussed briefly herein below:

- **Setting aside of sale on deposit of money**

Rule 60, Second Schedule Income Tax Act 1961, deals with the first category of setting aside of sale. The application for setting aside the sale in execution of certificate may be moved by the defaulter or any person whose interest are affected by the sale. The application is to be moved within 30 days from the date of the sale. The basic ingredient for setting aside the sale is that the applicant deposits the following sum with the tax recovery officer:

1. A sum equivalent to the amounts specified in the proclamation of sale for the recovery of which the sale was ordered along with interest at the rate of 15% per annum. The rate is to be calculated from the date of proclamation of sale to the date when the deposit is made;
2. A sum equivalent to 5% of purchase money as penalty to be paid to the purchaser.

The principles applicable for setting aside of sale of immovable property on deposit by the tax recovery officer are similar to the principles laid down in the Code of Civil Procedure 1908.

Setting aside of sale on ground of non-service of notice or irregularly

Rule 61, Second Schedule, Income Tax Act 1961, states that the sale may be set aside on the ground that the notice was not served to pay the arrears as required by Second Schedule, Income Tax Act, 1961, or on the ground of material irregularity in publishing or conducting the sale. The application could be moved either by the dependent or by any person whose interest are affected by the sale. The application is to be moved within a period of 30 days from the date of the sale.

It is further provided that the sale shall not be set aside on the ground of non-service of notice or irregularity unless the applicant is able to satisfy the recovery officer that he has sustained substantial injury on account of non service or irregularity. The expression 'substantial injury' cannot be defined in a strait-jacket formula, it is left to the satisfaction of the recovery officer to decide, if the substantial injury is made out.[17]

Where the applicant is the defaulter, the application shall not be allowed unless he deposits the entire amount recoverable from him, in the execution of the certificate with the recovery officer.

Setting aside of sale, where defaulter has no saleable interest

The application under this ground is maintainable only by the purchaser of the immovable property sold in execution of a certificate. The application has to be moved within a period of 30 days from the date of sale. The ground available is limited to the fact that the defaulter had no salable interest in the property sold.

The Second and Third Schedules of the Income Tax Act 1961 do not specifically deal with the situation where the possession of the immovable property is to be obtained either from the tenant or otherwise, except in Rule 11, Second Schedule of the Income Tax Act 1961, wherein it is stated under what circumstances and objections shall be disallowed.

The recovery officer attached to the debt recovery tribunal appoints a receiver for taking the possession of the property from the judgment-debtor or any person under him or a tenant. A receiver is given the power to remove any person from the possession or custody of the property and commit the same to the possession or custody of the purchaser.

- **Sales of Movables**

Section 25 (a) of the Act provides for sale of movable properties also. After issuing the recovery certificate and in satisfaction of the same, The Recovery Officer may cause the movables belonging to the Judgment Debtors be sold. An inventory shall be prepaid in the presence of two independent persons and the value of the movable asset shall be noted therein. And the major proportions to be taken are the following.

a. It must be asserting that the movable asset sought to be sold belong to the judgment Debtors.
b. If the assets are mixed up with those belonging to other persons, it should be ensured that such asset are not roughly sold

c. The sale shall not be one where the values of the assets are undervalued to the prejudice of the judgment Debtors.

All other conditions applicable to the sale of immovable property are also applicable to the sale of movable properties

- **Arrest of Persons**

Orders 21, Rule 37 to 40 of C.P.C. contain provision for arrest and the detention of judgment Debtor in execution of decree. The same provisions are applicable in the case of execution of Decree by DRT also. The mandate of Arrest is given to the Tribunal under Section 25 of the Act. For a better understanding of the position the Section is reproduced here under.

"The Recovery Officer shall, on receipt to the certificate under sub-section (7) if section 19, proceed to recover the amount of debt specified in the certificate by one or more of the following modes, namely:-

(a) attachment and sale of the movable or immovable property of the defendant;

(b) arrest of the defendant and his detention in prison;

(c) appointment a receiver for the management of the movable or immovable properties of the defendant.

- **Contempt Procedure**

The Tribunal is also deemed to be a Civil Court for the purpose of taking evidence, summoning witness, Execution of Decree etc. Therefore Disobedience of the order or the Tribunal will attract contempt proceedings. The Act under section 33 affords protection to Officers in respect of action taken in good faith.

However it is a question dispute whether the contempt of DRT would also extent to be actions taken by The Recovery Officers.

- **Advantages over Civil Suit**

The Establishment of DRT had served the purpose of banking Industry in providing a mechanism for easy adjudication of cases without going into the complicated procedural formalities. In DRTs the cases are adjudicated in a summary manner. Evidence can be adduced by way of affidavit in lieu of oral evidence. Only in case of extreme necessity cross examination is allowed. The time taken for adjudication of claim is very less compared to civil court where it varied from three to twelve years.

Executing a decree has become easier and more practical in DRTs. The entire work of execution is given to a separate authority called Recovery

Officer. Provision is made under the Act for executing the decree against the secured or attached assets by way of public Auction or private treaty. Sale by a private treaty provides ample opportunity for the banks to settle their claims at a faster pace.

- **Drawbacks in Procedure**

It is noticed that often proper adjudication do not take place in DRTs. The practice of taking evidence by way of affidavit some times to defeat the very purpose of fair trial. It is also complained that the Tribunals are more inclined to give decree in favour of the banks. Cross examination of witness is made a matter of discretion and usually it is not allowed. There is no machinery or procedure to determine disputes related to rate of interest.

- **Limitation of DRTs - an Appraisal**

In spite of getting twelve years lapsed after Enacting the legislation it is unfortunate that the Government has not framed the rules their under. The Tribunal is functioning on the strength of the Income Tax rules. The support staffs of the Tribunal are drawn from different Departments and therefore lack adequate legal Knowledge and rules.

The hands of The Law are not strong enough to catch hold of big defaulters. Large Defaulters and Corporate gaints usually manage to alienate their assets before recovery is effected. The lack of power on the part of the Tribunal to grant interim relieves as in the case in Civil Court also act as a stigma.

CHAPTER – VII

SECURITISATION AND RECONSTRUCTION OF ASSETS AND ENFORCEMENT OF SECURITY INTEREST

CHAPTER – VII

SECURITISATION AND RECONSTRUCTION OF ASSETS AND ENFORCEMENT OF SECURITY INTEREST ACT

➢ **Background of Legislates :-**

The reforms in the Banking and Financial Sector assume high priority in the liberalizing economy, as the globalization requires adherence by the Banks and the Financial Institutions to standards and yardsticks universally applicable. The rapid growth in the volume of business of the banks on account of liberalization and the introduction of prudential norms of income recognition and asset classification have; however, led to strains in the operational efficiency of Banks and in the accumulation of uncomfortably high level of Non Performing Assts (NPAs); which has been a major cause for worry in the post liberalization era and it has become necessary to bring them down to the internationally acceptable levels for creating a vibrant and competitive financial system. The concept of "quality of assets" and 'effective recovery measures' have also gained momentum in the financial sector.

Though financial sector reforms have always been a major agenda for our political economy ever since independence, the far reaching and vibrant reforms in this sector keeping tune with the international standards began in the year 1991; with the recommendation of the Committee on Financial System (CFS), popularly known as the 'Narasimham Committee'.

The Committee felt that there is an urgent need to work out a suitable mechanism through which dues to the credit institutions could be realized without delay. The Committee also recommended the establishment of an Asset Reconstruction Fund (ARF) which would take over from the Banks & Financial Institutions, a portion of the bad and doubtful assets at a discount[31].

The Committee emphasized the need for long term strategies for the reduction in Non Performing Assets and considered that speeding up the process for recovery as one of the most important areas which calls for reforms. The observation of the Committee on this point is as under:

"Banks and Financial Institution at present face considerable difficulties in recovery of dues from the clients and enforcement of security charged

[31] Malyadri & Sirisha :- NPAs in Commercial Bank – An Overview – Banking Finance – January 2003

to them due to the delays in the legal processes. A significant portion of the funds of banks and financial institutions is thus blocked in unproductive assets, the values of which keep deteriorating with the passage of time. Banks also incur substantial amounts of expenditure by way of legal charges, which add to their overheads. The question of speeding up the process of recovery was examined in great detail by a Committee set up by the Government under the Chairmanship of the late Shri. Tiwari. The Tiwari Committee recommended, inter-alia, the setting up of Special Tribunals, which could expedite the recovery process. This Committee is in full agreement with the recommendations made by the Tiwari Committee and strongly recommends to the Government that special legislation on the line recommended by Tiwari Committee be introduced forthwith. The Committee is of the view that unless a proper judicial framework is established which could help banks and institutions in enforcing the claims against their clients speedily; the functioning of the financial system would continue to be beset with problems."[32]

While stressing the need to take off at least a part of existing bad and doubtful debts of the banks and financial institutions from their balance sheets, the CTS further recommended as under:

"While the reform of accounting practices and the creation of Special Tribunals are essential, the Committee believes that an arrangement has to be worked out under which part at least of the bad and doubtful debts of the banks and financial institutions are taken off the balance sheet so that the banks could recycle the funds realized through this process into more productive assets. For this purpose, the Committee proposes the establishment, if necessary by special legislation, of an Assets Reconstruction Fund (ARF) which could take over from the banks and financial institutions a portion of the bad and doubtful debts at a discount, the level stipulated guidelines. The ARF should be provided with special powers for recovery somewhat broader than those contained in sections 29-32 of the State Financial Corporations Act, 1951. The capital of the ARF should be subscribed by the public sector banks and financial institutions."[33]

The Government and the Reserve Bank of India accepted most of the recommendations of the CFS and implemented provisioning income recognition and other prudential norms for the banks and financial institutions. By passing the Recovery of Debts Due to Banks and

[32] Narasimham Committee Report
[33] Ibid

Financial Institutions Act, 1993 and special Debt Recovery Tribunals were set up for speedy recovery.

As far as the recommendation to set up Asset Reconstruction Fund (ARF) for take over of bad and doubtful debts of banks and financial institutions, the same was not accepted and hence no ARF was set up. But at the same time Government recapitalized some of the weak banks and total recapitalization was to the tune of Rs.20, 000 crores.

In December 1997 Government decided that it was necessary to review the implementation of financial system reforms recommended by the Narasimham Committee (CFS) and to look ahead and chart the reforms necessary in the years ahead so that India's Banking System could become stronger and better equipped to compete effectively in a fast changing international economic environment. The Government therefore set up a high level committee under the Chairmanship of Shri. M Narasimham. This second committee on Banking Sector Reforms (Narasimham Committee-II) reviewed the implementation of the Narasimham Committee-I recommendation and in regard to Asset Reconstruction Fund made following observations:

"Banks and financial institutions should avoid the practice of 'evergreening' by making fresh advance to their trouble constituents only with a view to settling interest dues and avoiding classification of the loans in questions as NPAs. The Committee notes that the regulatory and supervisory authorities are paying particular attention to such breaches in the adherence to the spirit of the NPA definitions and are taking appropriate corrective action. At the same time, it is necessary to resist the suggestions made from time to time for a relaxation of the definitions of NPAs and the norms in this regard.[34]

So far, a sum of Rs.20, 000 crores has been expended for recapitalization and to the extent to which recapitalization has enabled banks to write off losses, this is the cost which the Exchequer has had to bear for the bad debts of the banks. Recapitalization is a costly and, in the long run, not a sustainable option. Recapitalization involves budgetary commitments and could lead to large measure of monetization. The Committee urges that no further recapitalization of banks be undertaken from the Government budget.

The Committee believed that the objective should be to reduce the average level of net NPAs for all banks to below 5% by the year 2000 and 3% by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPA to 5% and 3% by the

[34] Narasimhan Committee-II Report Chapter-II para 3.22

year 2000 and 2002 respectively and net NPAs to 3% and 05 by these dates. These targets cannot be achieved in the absence of measures to tackle the problem of backlog of NPAs on a one time basis and the implementation of strict prudential norms and management efficiency to prevent the recurrence of this problem.

The Committee is of the firm view that in any effort at financial restructuring in the form of taking off the NPA portfolio from the books of the banks on measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring. Cleaning up the balance sheets of banks would thus make sense only if simultaneously steps were taken to prevent or limit the re-emergence of new NPAs, which could only come about through a strict application of prudential norms and managerial improvement.

For banks with a high NPA portfolio, the Committee suggests consideration of two alternative approaches to the problem as an alternative to the ARF proposal made by the earlier CFS. In the first approach, all loan assets in the doubtful and loss categories – should be identified and their realizable value determined. These assets could be transferred to an Asset Reconstruction Company (ARC) which would issue to the banks NPA Swap Bonds representing the realizable value of the assets transferred, provided the stamp duties are not excessive. The ARC could be set up by one bank or a set of banks or even in the private sector.

In regard to legal framework for recovery the Narasimhan Committee made further recommendations as under:

"Given the unsatisfactory state of the law of mortgage, the response has been to vest through special statute the power of sale in certain institutions like Land Development Banks and State Finance Corporation. This approach could be extended to other financial institutions and, if possible, to banks. The other approach is to set up special tribunals for recovery of dues to banks and financial institutions. These Tribunals need to have powers of attachment before judgment, for appointment of receivers and for ordering preservation of property. For this purpose, an amendment to the concerned legislation may be necessary. The Committee would like to emphasize the importance of having in place dedicated and effective machinery for debt recovery for banks and financial institutions. (ChapterVIII, paras 8.2-8.4).

Securitization of mortgages is also critically dependent on the ease of enforcement and the costs associated with transfer of mortgages. The power of sale without judicial intervention is not available to any class of

mortgages except where the mortgagee is the Government or the mortgage agreement so provides and the mortgaged property is situated in Mumbai, Chennai and Calcutta and other towns so notified. Even if the power of the sale without judicial intervention were available there would need to be measures to put the buyer in possession. (Chapter VIII, paras 8.5-8.6).

The question of stamp duties and registration fees also requires review. There is a case for reducing stamp duties and registration fees substantially. (Chapter VIII, para 8.7)"

In addition to the above changes in the legal framework, the Committee also suggested amendments to other laws and in view of the wide ranging changes Narasimhan Committee-II recommended that an expert committee may be set up to look into suggested changes to the legal framework.

Accepting the above recommendations the Ministry of Finance set up an Expert Committee under the Chairmanship of Shri. T.R. Andhyarujina, former Solicitor General. The Expert Committee recommended enactment of new laws for following purposes:

i) Enforcement of securities for loans created over both movable and immovable properties by banks and financial institutions.
ii) Securitization of financial assets.

As a result, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 (2 of 2002) was promulgated by the President on 21st June, 2002. Since Parliament could not pass the Bill for converting the Ordinance into an Act, in the Monsoon Session, the Ordinance had to be re-promulgated by the President on 21st August, 2002 an Second Ordinance (3 of 2002). The Bill for conversion of Second Ordinance into an Act was passed by both the Houses of Parliament in the Winter Session of 2002 and the Bill as passed by the Parliament received President's assent on 17th December, 2002.

Enactment of SARFAESI Act 2002 :

The Enactment of the Securitization, Reconstruction of the Financial Assets and Enforcement of Security Interest Act, 2002; popularly known as the SRAFAESI Act; is the crystallization a concept that has been in vogue in India for almost one decade. The concept of 'Securitization' was limited to Securitization of good loan assets. Now the new Act has provided a platform for Securities of debt as an activity, which was

already in vogue. Thus, the Act is a dream comes true for the Banks and Financial Institutions as lenders.[35]

The Securitization Act 2002 is available to banks and financial institutions who can utilize this Act for recovery of their dues.

The expression 'Bank' has been defined in section 2(c) of the Securitization Act 2002, which includes a banking company, a corresponding new bank, State Bank of India, subsidiary bank or such other bank as Central Government may, by notification, specify for the purpose of this Act. The expressions banking company, corresponding new bank, subsidiary new bank, and State Bank of India have also been defined in the Securitization Act 2002.

A Financial Institution means a public financial institutions within the meaning of section 4(a) of the Companies Act 1956, any institution specified by the Central Government under the Recovery of Debts Due to Banks and Financial Institutions Act 1993, the International Finance Corporation established under the International Finance Corporation Act, or any other institution or non-banking financial company as defined in section 45-I of Reserve Bank of India Act, 1934 which may be notified specifically as financial institution for the purpose of this Act.[36]

> **Registration of Securitization or Reconstruction Companies :-**

The Act is a unique enactment as it has combined three heterogeneous concepts of 'Securitization', 'Asset Reconstruction' and 'Enforcement of Security Interest' into it. The only thing common in these three concepts, which are otherwise independent of one another, is that they are related to banking. Therefore it would be wise to discuss the salient features of the Act under the three heads separately.

(A) Securitization:

1. The provisions of securitization have been clubbed with provisions of enforcement of security interest and asset reconstruction. In fact, usually only a perfectly normal and performing asset, which has good credit rating, is securitized. Of course, non performing asset can also be securitized.

2. A securitization company can also act as asset Reconstruction Company, and *vice versa*.

[35] Najmi K.A:- R.B.I Legal News and Views – Jan-March., 2004
[36] Reserve Bank of India Legal news & views, Vol-9, October-December 2004

3. The basic data is to form an independent 'Securitization company' (In securitization terminology, it is termed as "Special Purpose Vehicle' (SPV). However, this term is nowhere used in the Securitization Act). Such company will have to be registered with RBI. (Section 3(1)). Such company will be Public Financial Institution u/s 4(a) of Companies Act.

4. The 'Securitization Company' can acquire any 'financial asset' (which is in nature of debt or receivable from bank/FI.. The 'asset' as such is not taken over.

5. In factoring also, receivable is acquired. However, the difference is that in factoring, only existing receivables (which are accrued but not due for payment) can be acquired, while in securitization, even future receivables can be acquired.

6. Purpose of securitization is to avoid mismatch between assets and liabilities of banks/FI. The lending company really 'sells' its loans to the investors through SPV.

7. The securitization company can acquire 'financial asset' from banks and financial institutions, by issuing debentures, bonds or by entering into any arrangement with Bank/FI. [Section 5(1)]. Once the securitization company takes over 'financial asset', that company will be treated as lender and 'secured creditor' for all the purposes. [Section 5(3)].

8. The securitization company will devise a separate scheme for each of the financial asset taken over. QIB (Qualified Institutional Buyers) will invest in such 'scheme'. The 'Securitization Company' or 'Reconstruction Company' will issue 'security receipt' to QIB. The security receipt will represent undivided interest in such financial assets. [Section 2(1) (zg)]. The securitization company will realize the financial asset and redeem the investment and payment of returns to QIB under each scheme. (Section 7).

9. Any dispute between Bank/FI, securitization or Reconstruction Company and QIB shall be compulsorily referred to conciliation or arbitration under Arbitration and Conciliation Act, 1996. [Section 11].

(B) Asset Reconstruction:

1. The provisions of 'asset reconstruction' combine the features of securitization and enforcement of security interest. Like securitization, in 'Asset Reconstruction' also, 'financial asset' (debt or receivable) is acquired from bank/FI, and not the asset as such. However, in asset reconstruction, the right or interest of any bank/FI is acquired for the purpose of realization of such financial assistance. Thus, non performing asset can alone be acquired for asset reconstruction.

2. The basic idea is to form a 'Reconstruction Company'. The Asset Reconstruction Company will have to be registered with RBI [section 3(1)]. Such company will be a Public Financial Institution u/s 4A of Companies Act.

3. A securitization company can also act as asset Reconstruction Company, and vice versa.

4. The 'Reconstruction Company' can acquire financial asset of Bank/FI for purpose of realization of the financial assistance.

5. Idea seems to be to hand over non performing assets in the banking sector to asset Reconstruction Company, so that Bank/FI can concentrate on their core business of lending.

6. The asset reconstruction company can acquire NPAs from banks and financial institutions, by issuing debentures, bonds or by entering into any arrangement with Bank/FI, [section 5(1)]. Once the asset reconstruction company takes over assets, that company will be treated as lender and 'secured creditor' for all the purposes [section 5(3)]. Since purpose is for realization of the financial assistance, only those assets which are classified by the secured creditor as 'Non Performing Assets' can be taken over.

7. The asset reconstruction company will devise a separate scheme for each of the financial asset taken over. QIB (Qualified Institutional Buyers) will invest in such 'scheme'. The 'Reconstruction Company' will issue 'security receipts' to QIB. The security receipt will represent undivided interest in such financial assets [section 2(1) (zg)]. The reconstruction company will realize the financial assets and redeem the investment and payment of returns to QIB under each scheme [section7].

8. Any dispute between Bank/FI, securitization or reconstruction company and QIB shall be compulsorily referred to conciliation or

arbitration under Arbitration and Conciliation Act, 1996 [section 11].

(C) Enforcement of Security Interest:

1. One very important aspect of the Act is that a secured creditor (Bank/FI) can enforce the security directly, without intervention of Court or Tribunal, after giving 60 days notice [section 13(1)]. If borrower does not pay the principal and interest as specified in the notice within 60 days, the secured creditor can take possession of assets, take over management of assets, appoint any person to manage the assets etc [section 13(4)].

2. This power can be exercised only if the asset is 'Non Performing Asset' as per guidelines prescribed by RBI. Broadly, NPA means that the interest or installment is overdue for a period exceeding 180 days.

3. Presently, these powers are only to Public Financial Institutions and banking companies. However, Central Government can extend these powers to other banks like cooperative banks, NBFC or any other Institution.

4. The secured creditor can sell the assets. If dues are not fully recovered, he can file application with Debt Recovery Tribunal for balance amount. He can also proceed against guarantors or sale the pledged assets directly [section 13(11)].

5. Instead of Bank/FI itself taking possession and selling the asset, the Bank/FI can hand over the asset to securitization or Reconstruction Company. That securitization or reconstruction company will then enter the shoes of Bank/FI and can act as if it is a 'secured creditor'. However, handing over asset to securitization or Reconstruction Company is at the option of Bank/FI.

6. Application can be filed by borrower with Debt Recovery Tribunal (DRT) only after the asset or management is taken over and not at the stage of receiving notice from secured creditor [section 17(2)]. Jurisdiction of Civil Court has been completely barred [section 34]. [Of course, writ petition can be filed with High Court at any time].

7. Appeal from order of DRT lies with Debt Recovery Appellate Tribunal. (DRAT] [Section 18(1)].

8. If borrower succeeds in appeal (at DRT or DRAT), he is entitled to get back possession of asset plus compensation and costs as may be fixed by DRT or Appellate Tribunal [section 19]. Thus, he is entitled to only 'compensation' and not 'damages'.

9. Protection of SICA will not be available once secured creditor takes steps for realization of assets. If any reference is pending with BIFR, it will abate. [Amendment to section 15(1) of SICA made by the Act]. [Drafting of the provision is not correct, as there can be dispute about interpretation of 'reference is pending' with BIFR].

In nutshell the Act achieve the following two objectives:

1. It provides 'private remedy' to a mortgagee by allowing him to foreclose the mortgage and invoke the securities without reference to the court and in this regard it is a substantial improvement on the laws; prior to this Act.

2. It makes it possible to for an Asset Reconstruction Company (ARC) to acquire or purchase the loan assets of the Banks and Financial Institutions together with underlying securities and allows such ARCs to enter into the shoes of the Banks and Financial Institutions with respect to their rights as secured creditors.

Apart from these, another significant features are that the Act, for the first time, defines 'hypothecation' [37] and also it extends the meaning of the term 'property' [38] by defining it in a manner as seen by a banker.

Acquisition Of Rights or Interest in Financial Assets :

Great powers have been given to the banks and financial institutions in recovering their dues from the defaulters. However before we discuss the powers available to the banks and financial institutions, it is necessary that we appreciate the ingredients that are necessary to bring a debt within the four corners of the Securitization Act 2002.

In order to avail the powers enshrined in the Securitization Act 2002, the following conditions must be fulfilled:

(i) existence of security interest;
(ii) in favor of secured creditors;

[37] Sec: 2(n)
[38] Sec: 2(t)

(iii) borrower must be under a liability to the secured creditor;
(iv) default in repayment of security debt or installment thereof;
(v) debt must be classified as a non-performing asset;
(vi) issuance of notice by the secured creditor to the borrowers.

We shall here in below deal with each of the abovementioned necessary ingredients to attract the provisions of the Securitization Act 2002.

➢ ***Existence of Security Interest***

The first and foremost ingredient to attract the Securitization Act 2002 is the existence of security interest in favor of the secured creditor.

The expression 'security interest' has been defined in section 2(zf) of the Securitization Act 2002 as right, title and interest of any kind upon property. The right, title and interest has to be created in favor of the secured creditor and includes within its ambit, mortgage, charge, hypothecation and assignment.

The expression, 'mortgage', 'charge' and 'hypothecation' have been explained in detail in Chapter III of this thesis. Briefly stating, mortgage and charge are governed by sections 58 and 100 of the Transfer of Property Act, 1882 respectively. Mortgage and charge can be created over an immovable property.

The expression 'hypothecation' is defined section 2(n) of the Securitization Act 2002 as a charge in or upon movable property created by borrower in favor of secured creditor, without delivery of possession of the movable property.

The expression 'assignment' means and includes a situation wherein a person who has a right over the property, assigns or transfer to another person the authority to use the right over the property. The property may include within its ambit movable and immovable property.

➢ ***Exception to Securitization Act 2002***

The securities as mentioned hereinabove admit certain exceptions, which shall not attract the provisions of the Securitization Act 2002. The exceptions are provided in section 31 of the Securitization Act 2002, and include the following:

(a) a lien on any goods, money or security given by or under the Indian Contract Act, 1872 or the Sale of Goods Act, 1930 or an other law for the time being in force;
(b) a pledge of movables within the meaning of section 172 of the Indian Contract Act, 1872;
(c) creation of any security in any aircraft as defined in clause (1) of section 2 of the Aircraft Act, 1934;
(d) creation of security interest in any vessel as defined in clause (55) of section 3 of the Merchant Shipping Act, 1958;
(e) any conditional sale, hire-purchase or lese or any other contract in which no security interest has been created;
(f) any rights of unpaid seller under section 47 of the Sale of Goods Act, 1930;
(g) any properties not liable to attachment or sale under the first proviso to sub-section (1) of section 60 of the Civil Procedure Court;
(h) any security interest for securing repayment of any financial asset not exceeding one lacs rupees;
(i) any security interest created in agricultural land;
(j) any case in which the amount due is less than 20 per cent of the principal amount and interest thereon.

Thus, it means that banks and financial institutions cannot exercise the powers conferred upon them under section 13(4) of the Securitization Act, 2002, in respect of any assets, which are either owned by the borrower or in the custody and possession of the borrower, where there is a prior interest of an independent party by way of a lien, pledge, conditional sale, hire-purchase, lease or as unpaid seller.

Further, where the security interest is in an aircraft or shipping vessel, agricultural land or property exempted from attachment under section 60, Civil Procedure Court, the Act shall not have any force. Besides, the Securitization Act 2002 shall not have any application where the value of security interest is less than Rs. one lacs or where 80per cent of consolidated amount of principal and interest has been paid.

- ***In Favour of Secured Creditor***

The second requirement to attract the provisions of the Securitization Act 2002 is that the security interest mentioned hereinabove be created in favour of the secured creditor.

This Act shall not have application where security interest is not created in favour of banks and financial institutions.

The expression 'secured creditor' has also been defined in section 2(zd) of the Securitization Act 2002. Broadly speaking, this Act defines secured creditors as those banks and financial institutions, in whose favour security interest is created for due repayment by any borrower of any financial assistance.

The expression 'banks and financial institutions' also includes the following:

(a) debenture trustee appointed by any banks and financial institutions;
(b) securitization company or reconstruction company;
(c) any other trustee holding securities on behalf of a banks and financial institutions.

a. Borrower must be Under a Liability to Secured Creditor

Further requirement of law is that the borrower must be under a liability to the secured creditor under a security agreement. The expression 'borrower' means and includes any person:

(a) who has been granted financial assistance by any bank or financial institution;
(b) who has given any guarantee;
(c) who has created any mortgage or pledge on security for financial assistance; and
(d) includes any person who has become borrower of any securitization company or reconstruction company.[10]

Default in Payment of Debt

Further requirement of the law to succeed in an action under this Act is that the borrower should have defaulted in payment of debt or any installment thereof.

If the borrower is paying debts in accordance with the payment schedule, the secured creditor cannot take benefits of this Act for early liquidation of its debt. Where, however, the debt is less than Rs one lacs or where more than 80 per cent of debt has been paid, default in payment of the same shall not attract the Securitization Act 2002.[11]

➢ *Non Performing Assts*

A debt, which has been defaulted in payment, must be classified as NPA. An account becomes NPA if it does not earn interest for a period of six months, or for a period specified by R.B.I. for classifying an account as N.P.A. from time to time.

This Act defines the expression 'non performing asset' in section 2(o) of the Act. In order to classify a debt as NPA, it must be classified by the banks and financial institutions as sub-standard, doubtful or loss in accordance with the guidelines lay down by the Reserve Bank of India. The concept and classification of NPAs have been discussed under Chapter IV of this thesis.

➢ *Notice of Demand*

Lastly, before initiating any action under the Securitization Act 2002, it is necessary that a mandatory notice be sent to the defaulter.

Section 13(4) of the Act contemplates a notice before resorting to the remedies provided under section 13 of the Act. It is required that the notice should be issued by the secured creditor in writing, wherein the secured creditor may require the borrower to discharge in full his liability to the secured creditor under section 13(4) with 60 days from the date of notice. If the borrower fails to pay up within the stipulated time, the secured creditor shall be free to proceed against the borrower under the provisions contemplated under section 13(4) of the Securitization Act 2002.[12]

The notice of demand should state the amount payable by the borrower to the secured creditor and the details of the secured assets intended to be enforced by the secured creditor in the event of non payment of secured debt.

It is incumbent upon the borrowers not to transfer by way of sale, lease or otherwise any of the secured assets after the receipt of notice. The transfer may take place with prior written consent of the secured creditor.

The Supreme Court in *Mardia Chemicals* case has held that the borrower shall have a right to reply to the notice and the banks and financial institutions shall consider the reply of the borrower before taking an action under section 13(4) of the Act. The borrower should be informed about the decision of the banks and financial institutions. This

judgment has given a breather to the borrowers against an action under section 13(4) of the Act.

➢ *Issue of Security by Raising Receipt or Funds*

As stated above, banks and financial institutions have been given wide powers to collect their dues. The powers are so exhaustive that initially this Act was addressed by some segments of society and industry as a draconian law. It needs to be seen how successful the banks and financial institutions are in taking the benefit of this Act.

The powers of the secured creditor under this Act have been stated in the Act. The powers, inter-alia, include the following:

(a) take possession of the secured assets of the borrower;
(b) take over the management of the secured asset;
(c) transfer the secured asset by way of lease, assignment or sale;
(d) appoint any person to manage the secured asset; and
(e) require the payment of the debt from the persons who acquire the same from the borrower.

Each of the above stated powers has been dealt with independently herein below.

Methods for Enforcement of Security

The action under section 13(4) of the Act may be broadly classified into two categories, which include:

(a) With the intervention of the court;
(b) Without the intervention of the court.

With the Intervention of the Court

Section 14(1) of the Act states that the secured creditor may seek the assistance of the court for the purpose of taking possession or control of secured asset. The secured creditor shall request, in writing, to the Chief Metropolitan Magistrate or the District Magistrate, as the case may, to:

(1) take possession of such asset and documents relating thereto; and
(2) forward such asset and documents to the secured creditor.

The application to the Chief Metropolitan Magistrate or the District Magistrate should contain in the case of mortgage:

(1) a copy of title deed,
(2) copy of memorandum of entry/memorandum of deposits of title deeds,
(3) copy of loan agreement / security agreement,
(4) a copy of notice of demand along with proof of dispatch thereof, and
(5) the statement of account subsequent to the expiry of the mandatory period prescribed under the Act.

If the Chief Metropolitan Magistrate or the District Magistrate if satisfied with the claim of the secured creditor, may without notice to the borrower take steps to take possession of such assets and documents from the borrower.

The said Chief Metropolitan Magistrate or the District Magistrate, on the receipt of the application may take the help of the force, as may in his opinion, be necessary to do to ensure smooth functioning of his duties.

Without the Intervention of the Court

As stated earlier, it not necessary that the secured creditor will have to take assistance of the courts in all cases. Wherever the secured creditor feels that he may take possession of the assets without the help of the court; he may not involve the court, in taking possession.[12]

➢ **Manner and Effect of Management Take Over**

Section 15 of the Act contemplates manner and effect of taking over the management of the borrower by the secured creditor. When the secured creditor takes over the management of business of a borrower, it may appoint directors in the company, if the borrower is a company defined in the Company Act, 1956, to be directors of the borrower. If the borrower is not a company the secured creditor may appoint an administrator of the business of the borrower

The appointment of directors or administrator may be notified by the secured creditor to the benefit of the general public by way of publishing a notice in two newspapers, one of which shall be in English and the other shall be in an Indian vernacular language of the place where the principal office of the borrower is situated. However it is not clear whether the notice shall be published in vernacular language itself. Taking the legislative intention, the overall scheme of the Act and the purpose it seeks to serve, it is advisable always to publish notice in vernacular newspaper in vernacular language itself. Now many of the

secured creditors resort to the practice of publishing notice in English in vernacular newspapers. But it is submitted as opposed to the spirit of legislative intention.[13]

The effect of publication in the newspapers in the case of a company is that all persons holding office as directors of the company, in case of a company; and persons holding powers of superintendence, direction and control of the business of the borrower in any other case, shall be deemed to have vacated their offices.

Further, any contract of management between the borrower and director or any other person shall be deemed to be terminated. The directors or administrator alone shall have the power to manage the affairs of the business after the publication of the notice in the newspaper.

Where the management of the secured creditor is taken over in the case of a company, it shall not be lawful for the shareholders or any other person to nominate or appoint any director of such a company. The resolution passed at the meeting of the shareholders, if any, shall not be given effect to unless approved by the secured creditor. Further, the company shall not be would up or a receiver appointed except with the consent of secured creditor.

The directors or administrator so appointed shall immediately take steps to take into their custody or under their control all the properties of the company, effects and actionable claims, which are of the business or appear to be of the business. The management of the business shall be handed back to the borrower by the secured creditor on realization of its debts in full.

Appoint any Person to Manage Secured Assets

The Act contemplates appointing a person as manager of the properties, the possession of which was taken over.

The appointed manager shall have the right to perform all the functions, which a secured creditor could have done, including transfer by way of a lease, assignment or sale for realizing the secured assets.

The transfer made by the manager shall vest in the transferee all rights in the property as if the owner of the secured asset himself made the transfer. The manager so appointed may also take-over the business of the borrower and may run the business after being appointed as the director or the administrator of the business.

Transferee Required Paying the Debts

The law earlier suffered from the limitation of not being able to recover the more if the property, which was secured, was transferred to another person. Creating a third party interest in the property secured by the banks and financial institutions may not be a valid transfer in the eyes of law. However, the lender always felt the difficulty in recovering the money from the third party.[14]

The Securitization Act, 2002 has given the powers to the banks and financial institutions to recover the money from such transferees, which was due or may become due to the borrower by requiring them by way of a notice in writing to pay the amount to such secured creditor. This demand of money is subject to the maximum of such money as is sufficient to pay the secured debt.

Sub-section (5) of section 13 of the Securitization Act, 2002 provides that if a thirty party makes the payment due to the borrower to the secured creditor in obedience of the notice mentioned above, such payment shall discharge such third party to the extent of the payment made on behalf of the borrower.

➢ ***Costs, Charges and Expenses***

All cost, charges and expenses which have been incurred by the secured creditor in taking any action under sub-section (4) of the section 13 shall be recovered from the borrower. The money received by the secured creditor subsequent to an action under sub-section (4) of section 13 shall, subjects to contract to the contrary, shall first be applied in payment of such cost, charges and expenses incurred in taking action under sub-section (4) of section 13 of the Act. Thereafter it shall be applied in discharge of debt dues of the secured creditor. The balance funds, if available, shall thereafter be payable to the person entitled thereto in accordance with his rights and liabilities.

If the costs, charges and expenses along with the debt of the secured creditor are tendered by the borrower to the secured creditor at any time before the date fixed for sale or transfer, such secured assets shall not be sold or transferred by the secured creditor and no further steps shall be taken by him for transfer or sale of the secured assets.[15]

➢ ***Joint Financing***

Sub-section (9) of section 13 of the Act states that in the event of joint finance by more than one secured creditors in respect of a single secured assets, no secured creditor shall alone be entitled to exercise the powers contemplated in sub-section (4) of section 13 of the Act. The powers so given shall be exercised by the secured creditor only in situations where secured creditor representing at least three fourth in value of the amount outstanding on a record date agree to exercise the rights.

The action taken by a secured creditor with the consent of other secured creditors shall be binding on all the secured assets.

- ***Guarantors***

The secured creditor is at liberty to proceed against the guarantor or sell the pledged assets without first taking any measures specified in clause (a) to (d) of sub-section 4 of section 13.

- ***Balance recovery***

Where the amount recovered by the secured creditor from the sale proceeds of secured assets is less than the amount due, the secured creditor may approach the concerned DRT for the recovery of balance amount from the borrower. Subject to the Pecuniary Jurisdiction.

- ***Limitation***

The proceedings under sub-section 4 of section 13 can be invoked only if the claim is within the period of limitation prescribed under the Limitation Act, 1963.

- ***Appeal Provisions***

Section 17 of the Securitization Act, 2002 as it was originally enacted provided for an appeal against the action of the secured creditor under section 13(4) of the Act.

The appeal had to be made to the DRT within 45 days from the date on which such measures had been taken. Earlier, there was a provision, which provided that an appeal against the measure of section 13(4) of the Act shall be entertained only on the deposit of 75 per cent of amount claimed in the notice. The Supreme Court in *Mardia Chemicals* has

declared this provision ultra virus of the Constitution, and the stipulation regarding deposit of 75 percent of amount was struck down. It was also observed that the terms `prefer an appeal' is a misnomer and now the position is that an application shall be filed to DRT v/s. 17 and if aggrieved by the order of DRT an appeal can be filed before the Debt Recovery Appeallicate Tribunal (DRAT). The applicant or appellant filing such application or appeal is required to pay such court fees applicant in the case of Original Application or Appeal as the case may be.

Benefits of Securitization:

1. Lower Cost

Cost reduction is one of the most important motivations in securitization. Securitization seeks to break an originating company's portfolio into echelons of risks, trying to align them to different investor's risk appetite. This alchemy supposedly works-the weighted overall cost of a company that has securitized its assets seems to be lower than a company that depends on generic funding.

Securitization enables the originator to achieve a rating arbitrage-obtain a rating that a generic funding could not have. Such a rating is possible due to the structural enhancements in securitization. The direct impact of lower borrowing costs is on lower lending costs. Mortgage rates in many countries fell after securitization was introduced or became popular. Many banks also claim to be running on lesser lending costs due to securitization.

2. Alternative investor base

Without disturbing the existing lenders, securitization extends the pool of available funding sources to an entity by bringing in a new class of investors. For many entities, typical securitization investors such as insurance companies, asset mangers, pension funds and the like may not be available for access, other than for investment in a securitization program.

3. Perfect matching of assets and liabilities

Asset liability mismatch is a serious issue for financial intermediaries such as banks and finance companies. It refers to the maturity mismatch between assets and liabilities. Mismatch spells either higher risk or higher costs, and therefore, intermediaries try to strike a near perfect match between maturities of assets and liabilities.

4. Makes the issuer rating irrelevant

Being an asset based financing; securitization may make it possible even for a low rated borrower to seek cheap finance, purely on the strength of the asset quality. Hence, the issuer makes him irrelevant in a properly structured securitization exercise.

5. Multiplies asset creation ability

Securitization makes it possible for the issuer to create any amount of asset with given equity. The securities create assets and then parts with the same. In essence, therefore, the issuer acts as a manufacturer and inventories of assets. The extent of assets he can created is therefore solely dependent on his "conversion cycle", that is, the period that lapses between the date an underlying receivable is created and is marketed.

6. Allows higher funding

A traditional financier looks at the assets on the balance sheet and lends a fraction thereof. For example, a typical bank funding capital will look at the working capital gap and fund a certain percentage. Securitization investor look at the cash flows in further. Which are not necessarily on the balance sheet so the issue might end up getting a higher amount of funding through securitization than by conventional funding methods?

7. off balance sheet financing

Financial intermediaries look at securitization essentially as an off balance sheet funding method. Off balance sheet feature could be looked at either from accounting standards viewpoint, or from regulatory viewpoint. The latter is relevant for computation of regulatory capital or capital adequacy requirements.

The tendency of financial institutions is to prefer off balance sheet funding over on-balance sheet funding is because the former allows higher returns on assets, and higher returns on equity, without affecting the debt equity ratio. As tools of managerial performance, these have a definite relevance.

Securitization allows a firm to create assets, make income thereon, and yet put the assets off the balance sheet the moment they are transferred through securitization device. Thus, the income from the asset is accelerated and the asset disappears from the balance, leading to an improvement in both income related ratios as also asset-related ratios.

8. Helps in capital adequacy requirements

One of the very strong motivations for securitization is that it allows the financial entity to sell off some of its on balance sheet assets and thus remove them from the balance sheet and hence reduce the amount of capital required for regulatory purposes. Alternatively, if the amount raised by selling on balance sheet assets is used for creating new assets, the entity is able to increase asset. Creation without a haircut for its capital.

9. Improves capital structure

By being able to market an asset outright securitization avoids the need to raise a liability and hence, it improves the capital structure. The improvement of capital structure as a result of lower debt equity ratio may not be mere accounting gimmick-if securitization results into either transfer of risks inherent in assets or capping of such risks, there is a real re-distribution of risk taking place, leaving the firm with a healthier balance sheet and reduced risk.

10. Better opportunity of trading on equity with no increased risk

The ability to create assets, as a result of off balance sheet treatment and regulatory freedom results into more profits and hence a stronger firm.

11. Extends credit pool

Securitization keeps the other traditional lines of credit undisturbed. Hence, it increases the total financial resources available to the firm. Securitization has been tried by many firms in addition to regular borrowings, not in place of.

12. Not regulated as a loan

Corporate laws in some countries have laws regulating borrowing abilities of financial companies, since financial companies are taken as Para banking companies. Securitization does not suffer borrowing related fetters, as it is not taken by regulation to be debt. For example, a regulation relating to borrowings from public will not be attracted, since a securitization is not a case of borrowing.

In India, for example securitization will escape regulation pertaining to rising of deposits by financial companies; as such regulation is a part of the law, not prudential regulation.

13. Reduces credit concentration

Securitization has also been used by many entities for reducing credit concentration. Concentration, either sector or geographical implies risk. Securitization by transferring on a non recourse basis exposure by an entity has the effect of transferring risk to the investor.

14. Avoids interest rate risk

One of the primary motives in securitization of mortgage receivables was to transfer interest rate risk to the investors. The lenders were subject to the risk since the mortgages carried a fixed rate of return while the loans taken by the lenders had a variable rate. When the mortgages were securitized, the lender made an instant spread on the basis of a fixed rate, and therefore, completely avoided the price risk.

15. Arbitraging by repackaging

Securitization has been used by number of banks and fiancé professionals for arbitraging purposes: that is bought up assets from the market at higher spreads, accumulate them, provide or organize enhancements and securities them. These transactions are sometimes called repackaging transactions-giving a net arbitrage profit to the repackage.

16. Arbitraging on liquidity and term structure

A significant aspect of securitization structures, particularly relating to long term receivables, is that the originator makes profits by arbitraging on the yield differences in term structure of interest rates. In CMO trenches, for example long term mortgages were de-composed into shorter-term securities each paying successively. In the process, the securities were able to lower down his cost, and the arbitrageur was able to make profits.

17. improves accounting profits

Securitization allows upfront recognition of profits. The profit is the difference between the average spread inherent in the financial asset and weighted average return provided to the investors. Accounting standards permit the up fronting of this profit if the securitization transaction satisfies certain requisites.

Advantages to the Inventors:

All over the World, investors, particularly, institutional investors have shown active interest in investing in securitized products. Rating agencies have helped in promoting these interest levels since most securitized products have obtained good ratings. Securitization offers three features that investors will love to have in any investment option: good rating, rating resilience and good spreads.

1. Better security

Securitized instruments are devices of asset-backed finance. The investors have a direct claim over a portfolio of assets, often diversified and reasonably credit enhanced. Investors are not affected by any of the risks that beset the originator. Thus, securitization investments are far safer than investing directly in debt or equity of the originator.

2. Good ratings

Many-structured finance has obtained good ratings. With increasing institutionalization of investment function, investments are being managed by professional managers who would prefer a formally rated instrument to an unrated one. Rated investments are now preferred all the more because of a regulatory advantage conferred by a new capital adequacy framework proposed by the bank for international settlements.

3. Rating resilience

Rating resilience stands for the stability of a rating after issuance. For securitization issuance, both Moody's and Standard and Poor's recently published rating resilience studies, which indicate that securitization investments are considerably safer than investments in corporate debt.

4. Better matching with investment objectives

Securitized instruments have a great flexibility to match with the investment objectives of the investors. Similarly, investors can look at investing over a short term, medium term or long term. It is even possible for investors to go for a fixed rate investment, floating rate investment or inverse floating rate investment.

5. Good spreads

Securitized offerings have good yields with adequate security. Empirical data about securitization offerings reveal that an investor who

maintained a good balance of emerging market and developed market offerings has been able to come out with good rates of return.

6. Few instances of default

History provides far lesser incidents of default and loss in securitization than in corporate debt. In Europe, for example there is no instance of default at all so far in almost a decade of securitization issuance.

Economic and Social Impact of the Act:

1. Facilitates creation of markets in financial claims

By creating tradable securities out of financial claims, securitization helps to create markets in claims, which would, in its absence, have remained bilateral deals. In the process, securitization makes financial markets more efficient, by reducing agency costs.

Since financial assets are tradable, it also reduces the liquidity risks in the financial system. Liquidity related problems have been responsible for a number of economic crises: recently Japanese crises and South East Asian crises. Securitization can help financial intermediaries better manage asset liability mismatches and therefore avert liquidity problems. Result, the need for risk capital that is needed, among other things, for supporting liquidity also comes down.

2. Disperses holding of financial assets

The basic intent of securitization is to spread financial assets amidst as many savers as possible. With this end in view, the security is designed in minimum size marketable lots as necessary. Hence, it results into dispersion of financial assets. Recent securitization applications, viz., mortgages, receivables, etc. are therefore yet to become acceptable to lay investors.

3. Promotes Savings

The availability of financial claims in a marketable form with proper assurance as to quality in form of credit ratings, and with double safety nets in form of trustees, etc., securitization makes it possible for the lay inventors to invest in direct financial claims at attractive rates. This has salubrious effect on savings.

4. Reduces costs

Securitization tends to eliminate fund based intermediaries, and it leads to specialization in intermediation functions. This saves the end-user company from intermediation costs, since the specialized intermediary costs are service related and generally lower.

5. Diversified risks

Financial intermediation is a case of diffusion of risk because of accumulation by the intermediary of a portfolio of in. risks. Securitization further diffuses such diversified risk to a wide base of investors, with the result that the risk inherent in financial transactions gets very widely diffused.

6. Focuses on use of resources and not their ownership

Once an entity securitizes its financial claims, it ceases to be the owner of such resources and becomes merely a trustee or custodian for the several investors who thereafter acquire such claim. In this sense, securitisation carries Gandhi's idea of capitalist being a trustee of resources and not the owner.

7. Smoothens impact of recession

In 1991, when the US economy was passing through recession, securitisation was booming. A December 1991 article in the Institutional Investor said "The asset backed securities market is roaring its way through the recession with record issuance and reliable performance that prove it has come of age." In the year 2001-2002 the global economy passed through multifarious problems-large bankruptcies, terrorism, etc. However, securitisation markets have continued to grow through all this, and the growth has been wide spread across different sectors. Evidently, more money is being raised by credit card securitisation than in the past-which means consumer spending is being spending propped by capital markets. More auto loans have been securitised in 2002 than in the past. All this tends to ease out the impact of economic recession.

The constitutional validity of the SARFAESI Act was examined by the Hon. Supreme Court is Mardia Chemicals Ltd Vs Union of India. The main challenge to the Act was that the banks and financial institutions had been vested one sided and unguided arbitrary powers on the banks to recover the dues. Besides that the Act did not provided any appropriate and adequate mechanism to decided dispute relating to the correctness of he demand, its validity and actual amount due to the banks etc.

Taking into consideration the submission made by the parties, the Supreme Court inter alia framed the following issues for adjudication.

(i) Whether it is open to challenge the statute on the ground that it was not necessary to enact it in the prevailing background particularly when another statute was already in operation?

(ii) Whether provisions as contained under Section 13 and 17 of the Act provide adequate and efficacious mechanism to consider and decide the objections/disputes raised by a borrower against the recovery, particularly in view of the bar to approach the civil court under Section 34 of the Act?

(iii) Whether the remedy available under Section 17 of the Act is illusory for the reason it is available only after the action is taken under Section 13(4) of the Act and the appeal would be entertainable only on deposit of 75% of the claim raised in the notice of demand?

(iv) Whether the terms or existing rights under the contract entered into by two private parties could be amended by the provisions of law providing certain powers in one-sided manner in favour of one of the parties to the contract?

(v) Whether provision for sale of the properties without intervention of the court under Section 13 of the Act is akin to the English mortgage and its effect on the scope of the bar of the jurisdiction of the civil court?

(vi) Whether the provisions under Sections 13 and 17(2) of the Act are unconstitutional on the basis of the parameters laid down in different decisions of this Court?

(vii) Whether the principle of lender's liability has been absolutely ignored while enacting the Act and its effect?

Considering the points put forward by the parties, the recommendations of Narasimhim Committee, and the changes in the global economy, Supreme Court upheld the constitutional validity of the Act, stating that in view of the changing global economy, it may difficult to stick to old and conventional method of financing and recovery of dues. Further it was held that the condition of pre deposit of 75% of the dues or filing appeal (Section 17 (2)) was bad rendering the remedy. At this juncture, it would be interesting to quote the following from the judgment.

"The effect of some of the provisions may be a bit harsh for some of the borrowers but on that ground the impugned provisions of the Act cannot be said to be unconstitutional in view of the fact that the object of the Act is to achieve speedier recovery of the dues declared as NPAs and better

availability of capital liquidity and resources to help in growth of economy of the country and welfare of the people in general which would sub serve the public interest"

- **Drawbacks and Limitation:**

This researcher came across the following limitations in the operational Scheme of the act. (i) Sec: 13 (4) (1) permits a secured creditor "to take possession of the secured assets" of the borrower including the right to dispose it off for realizing the secured assets.

The Act also permits a secured creditor "to take over the management of the secured assets" of the borrower including the right to dispose of the assets. The intention seems to be that section 13(4) (1) would get attracted if the unit is closed and section 13(4) (b) would get attracted if the unit is still in operation. However, a bare reading of the provisions does not necessarily reflect this view and at the stage of implementation, these two phrases may create confusion, especially, in cases where a unit when taken over u/s 13(4(a) was closed but is likely to fetch much higher price if brought into operation and then disposed of as a running unit.[16]

(ii) Section 9 uses the phrase "management of the business of the borrower" and section 15 deals with the situation where the management of the business of the borrower" is taken over by the secured creditor. As against this, section 13 (4) (b) refers to 'take over of the management of the secured assets". Since these phrases have nowhere been defined, it is not clear as to how 'taking over the management of the secured assets' is different from "taking over the management of the business of the borrower". It is, therefore, desirable that intention of the legislature is clearly explained in using different terminologies in different sections, more so, in section 9, 13 and 15. This section tends to bring in a series of litigation involving the constitutional validly of the section itself.

(iii) Whether the intention of the legislatures in framing section-9 and 13 is that a securitisation/reconstruction company can take over the "management of the business of the Borrower" and "bring in change in the management, if considered necessary, but a secured creditor can only take over "the management of the assets:. Does it mean that a secured creditor can take over only closed units and see whether the unit could be operated upon and if unit is running then only an ARC can take over possession of such units? Or does it mean that taking over of the management of assets of the borrower necessarily imply the right to change the management? These issues need to be clarified by suitable guidelines/regulations to be issued by RBI.

(IV) Section 13(4) empowers the secured creditors to take possession of the assets after giving the borrower sixty days notice. This is a sufficiently long time for unscrupulous borrowers, to rob the company of, all good assets. There is no mechanism provided in the Act to ensure that within the period of sixty days, the secured creditors remain assured that the assets would not be tampered with.

(v) In the event of a claim application or suit pending before any court or Tribunal; against a borrower whose assets have been acquired under section 13(4) of the Act, the claim application would remain pending and in the meantime the secured assets would be acquired and disposed of. Hence, there is need for a specific provision to say that "on an application to be filed by secured creditors, wherever necessary, the claim application or suit shall be kept in abeyance with liberty to continue the proceedings for balance dues after action under section 13(4) is complete."

(vi) Section 17 of the Act permits any person (including borrower) aggrieved by any of the measures referred to in Section 13(4) taken by secured creditors, to prefer an appeal to the Debt Recovery Tribunal within 45 days from the date on which such measures have been taken. The scope of the section is too wide and it allows not only the borrower but also any other person, which may include the shareholders, workers, sundry creditors, etc. to file an appeal against the action of the secured creditor taken in terms of section 13(4) and create hurdles in invocation of the right of the secured creditor to invoke the security without reference to Court granted under the Act. It is therefore desirable that the right is restricted to the borrowers and the actual owners of the assets which have been taken over or purported to be taken under the Act.

(vii) Section 15 lays down the manner and effect of taking over of the management. Section 15(4) says, where the management of the business of the borrower had been taken over, the secured creditor shall, on realization of his debt, restore the management of the business of the borrower. This obviously means that taking over the management or bringing in any change in the management has to be temporary phenomena and after realization of the debt, the management has to be restored back to the original promoters. Thus, the Act seems to provide that Asset Securitisation/Reconstruction Company has the power of taking over of the management of the business of the borrower for the limited purpose of restructuring/ rehabilitating the company. Assuming it decides to dispose of all the assets of the Company, then in such a situation whether it has to pass on the shell company to the original promoters and if so, it is not clear as to what would be the modalities of

such transfer?. In this circumstance it is suggested that suitable rules may be framed or guidelines issued in this regard.

(viii) In terms of section 17 of the Act, any person aggrieved by any of the measures taken by the secured creditor, may approach DRT. Thus the present scope of the powers of the DRT has been enlarged. Consequently, Darts are to be bestowed with powers to hear such applications/appeal. However, the statute is silent on this count. There is need to carry out consequential amendment in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993.

(ix) There is need for a forum to break the cartelization by the bidders and to function as a market maker for second hand plant/ machines and other assets. This role can be played very effectively by ARCs. If ARC has to carry on this function, it would need permission from RBI in terms of Section 10(2) of the Act. IFCI alone has got 148 Rocs/sale orders issued by DRTs/Company courts for an amount of Rs.1407 cores. It would greatly help the cause of assets resolution and its monetization if RBI grants general permission in favour of ARCs to participate in bids as on independent business activity. Under the present norms, our ARC is not expected to carry on this activity.

The Doctrine of Sovereign Debt and enforcement of security interest:

The common law doctrines that crown debt has priority over other debts acknowledge the pre-eminence that the sovereign enjoys over all other persons. It has been contended before the courts that recovery of the amount due to Government from a citizen must take precedence and priority over dues from the said citizen to his other creditors. The question about applicability of crown prerogative in India was considered by Bombay High Court as early as in 1868. In Secretary of State and Council of India vs. the Bombay Lending & Shipping Company Ltd.[17] (1868-69) 5 Bombay SCR Page-23, We strop J held that a judgment debt due to crown was in Bombay entitled to the same precedence in execution as in England. The learned Judge also observed that the common law doctrine was "no novelty in India" and he referred to the Rule enunciated by Yajnavalkya, who said "a debtor shall be forced to pay to the creditor in the order in which the debts were contracted after first discharging those of a priest and the king." He also added that "Muhammadan sovereigns were not prone to waive or abandon such royal prerogative as they found in India.

In Builder Supply Corporation vs. Union of India represented by the Commissioner of Income Tax, West Bengal & others.[18] (1965) 2 SCR 289/AIR 1965 Supreme Court 1061, the Humble Court was called upon to consider whether the decrial dues of the appellant, at whose instance

certain property of respondent No.2 had been attached, will have precedence over the tax dues of respondent no.1, the Govt. of India, due and payable by respondent no.2? The Income Tax Act provided for certificate procedure for recovery of income-tax dues as arrears of land revenue. Referring to the decision of the Bombay High Court in Bank of India vs. John Bowman & others.[19] AIR 1955 Bombay 305, where it was held that "the priority given to the crown is not on the basis of its debt being a judgmental or debt arising out of a statute, but the principle is that if the debts are of equal degree, and the Crown and the subjects are equal, the Crown's right will prevail over that of the subject. A debt owed to a decree holder was held to be "unsecured debt". Referring to the various decisions of the High Courts on the issue, the Court observed that recovery of amount of tax due from a citizen must take precedence and priority over the "unsecured debts" from the said citizen to his other private creditors.

A reference is made to the decision of the Supreme Court in case of Bank of Bihar vs. State of Bihar & others.[20] (Air 1971 SC 1210). The question to be examined by the Supreme Court was whether the rights of the Pawnee, who had parted with money in favour of the pawnor on the security of the goods, could defeated by the goods being lawfully sixed by the Government and whether the money could be made available to other creditors of the pawnor, without the claim of the Pawnee being fully satisfied. The Court observed that a Pawnee had a special property and a lien, which is not of ordinary nature and so long as his claim is not satisfied, no other creditor of the pawnor has nay right to take away the goods or its price. In this case, the District Magistrate, Patna, under the Public Demand Recovery Act, seized certain bags of sugars pursuant to lawful orders made by him and the sale proceeds of 5000 mds. Of sugars were deposited with the Treasury and were, subsequently, attached under the orders of certificate officers, Patna under the Public Demand Recovery Act on account of the arrears of "sugar cess" amount to Rs.2.00 lakhs. Deciding the case, the Hon'ble Supreme Court observed the right of Bank of Bihar "as a Pawnee could not be extinguished by the seizure of the goods in its possession, inasmuch as the pledge of the goods was not meant to replace the liability under the cess credit agreement. It was intended to give the plaintiff a primary right to sell the goods in satisfaction of the liability of the pawnor. The Cane Commission, who was an "unsecured creditor", could not have any higher right than the pawnor and was entitled only to the surplus money after satisfaction of the claim of Bank of Bihar. "This case, thus, established that the crown debt will have priority only against the claim of "unsecured creditors" and not against the claim of the "secured creditors". The judgment, as given in the case of Bank of Bihar vs. State of Bihar, has been referred and relied upon in various subsequent judgments. Thus in State vs. Andhra Bank and others.[21](AIR 1988 AP

18) when the tehsildar attached the stocks of sugar hypothecated to the plaintiff bank for recovery of a sum of Rs.5.2 lakhs due towards sugarcane 'purchase tax' to the State under the provision of "AP Sugarcane (Regulation of Supply & Purchase) Act", it was held that the "hypothecate, viz., the Bank has a lien on the goods which are held by way of security and the bank as a "preferential claim as a secured creditor" even against the Government's demand of taxes".

Again, in the case of Indian Bank v. State of Andhra Pradesh and others.[22] (1993 STC page 548), it was held that "while land revenue and public revenue are secured debts for recovery of which there lies a charge on the land and buildings upon it, other amount recoverable as arrears of land revenue, are not secured debts. Sales tax arrears of a defaulting dealer are not a secured debt. Therefore, the Sales Tax Department does not have a prior claim on the proceeds of the sale of property hypothecated to the Bank, a secured creditor, which are brought to sale in a suit instituted by the secured creditor." Similarly in Satyam v. Krishna Murthy & others.[23] (AIR 1969 AP 237), it was held that "Having regard to the strong line of authority, I hold that the sale in the instant case for recovery of arrears of Income-tax subsequent to the mortgage, did not have the effect of superseding the rights of the mortgagee nor giving him any priority over the rights of the mortgagee". In SITANI TEXTILE & FABRICS (P) LTD. V. ASSTT. C. OF CUS & C.E., HYDERBAD.[24] (1999-(106) – ELT – 0296 – AP) one M/s. Dakshin Fabrics Ltd., had taken a loan from AP Industrial Development Corporation, a financial institution. Since there was default in payment of loan, the unit of Dakshin Fabrics Ltd, was brought to sale under Section-29 of the State Financial Corporation Act, 1951 on 4/2/92. The Supdt of Central Excise had detained the plant and machinery of M/s. Dakshin Fabrics Ltd. On the ground that it had to pay a sum of Rs.8, 27,792.19 ps. In terms of adjudication order nos. 4/90 dated 9/3/90 and 79/90 dated 11/11/90. Aggrieved by the orders of adjudication and also the order of demand dated 21/2/94 and 13/6/94, a writ petition was filed.
It was held that –

(a) "In the case of pledge, Pawnee has special property and lien which is not of an ordinary nature on the goods and so long as his claim is not satisfied, no other creditor of the pawnor has any right to take away goods or its price. The right of a Pawnee could not be extinguished by the subsequent attachment/seizure of the goods under any other law. It gives the Pawnee a primary right to sell the goods in satisfaction of the liability of the pawner. An unsecured creditor could not have any higher right than the pawnor and was entitled only to the surplus money after satisfaction of the secured creditors' due. The above principle applied to hypothecation as well as the mortgage. A mortgage is a transfer of an interest in

immoveable property. Hence, mortgagee has a preferential right over other unsecured creditors. On this basis, the Court held that "AP Industrial Development Corporation, being secured creditors, has a preferential claim even against demand of Central Excise duty of the Government".

Reference is also made to DENA BANK v. Bhikabhai Parachutes Parikh & Company. And others, Respondents – 2000 (SUP) – AIR – 3654 – SC. Having reviewed the available judicial pronouncement regarding priority of Government debts, the Court observed that (i) there is a consensus of judicial opinion that the arrears of tax dues to the State can claim priority over private debt; (ii) the Common Law Doctrine about priority of crown debt recognized by India courts, prior to 1950, constitutes law in force within the meaning of Article 372 (1) of the Constitution and continue to be in force. The basis justification is the necessity and wisdom of conceding to the State the right to claim priority in respect in respect of its tax dues. The doctrine may not apply to the debts due to the State if they are contracted in relation to the commercial activities, which may be undertaken by the State. However, the crown's preferential right to recovery of debts over other creditors is confide to the claims of ordinary or unsecured creditors. The Common Law of England or the principal of equality and good conscience (as applicable in India) do not accord the crown a preferential right for recovery of its debts over a mortgage or a pledge of goods. It is only in cases where the crown's rights and that of the subject meet at one and the same time, that the crown is, in general, preferred. The Court also referred to Rasbehary Ghose's observations "it seems that a Government debt in India is out entitled to precedence over a prior secured debt"[25] And yet referring to Section-151 of the Karnataka Land Revenue Act, 1964, the Supreme Court finally held that the State usually have a preferential right to recover its dues over the secured creditors. It is respectfully submitted that the land revenue has a first charge over the landed property and merely because the sales tax is recoverable "as arrears of land revenue" that does not provide the sales tax dues, the same priority as is enjoyed by "land revenue". It needs to be appreciated that the provisions of Public Demand Recovery Act for recovery of land revenue lay down the procedure and they have nothing to do with the priority of the debt. This has been made clear in a number of decisions of the Hon'ble Supreme Court itself, including in the case of Builder Supply Corporation vs. Union Bank of India where the Court had held that the Public Debt Recovery Act is not directly concerned with the right to recover the arrears, or, with priority, of tax dues. Arrears of tax fall

25. Ghose; Rasbehary :-Law of Mortage VII Edn: P.186

recover the arrears, or, with priority, of tax dues. Arrears of tax fall within the scope of the proceedings contemplated by it.

In other words, the Public Debt Recovery Act deals only with the procedure for recovery of loan and is, in no way, concerned with the priority of crown debt. If a particular tax dues is recoverable "as arrears of land revenue", it does not mean that such recovery will have precedence over the debt of a "secured creditor" whole confusion about "Doctrine of Crown Debt" can be avoided and Banks and Files can be saved from frequent litigations on this issue initiated by various departments of the central/State Governments like Income Tax, Excise, Customs, Sales-tax etc., by inserting suitable provision, to say that the priority of crown debt, as stipulated under different Statute, is with reference to "unsecured debts" and has not application as against "secured debts".

Impact of Relief Undertaking Act on the enforcement of securities:

The Sick Industrial Companies Act, 1985 was promulgated, more or less, on the lines of United States, to encourage rehabilitations of viable units and early liquidation of units which required winding up. We have seen how the SICA provided a large field to defaulting borrowers to play the game of hide and seek with the lenders.

The Eradi Committee, therefore, recommended abolition of BIFR. It suggested that the possibility of rehabilitation, as also the need for liquidation of a company, should be decided by a single forum and suggested establishment of National Company Law Tribunals, before making these recommendations, the Committee had occasion to study the Company Laws of various jurisdictions and had observed that in a large number of countries, there is a single forum to consider rehabilitation and, if necessary, carry out liquidation. The "days of debtors playing hide and seek with the creditors" on account of the provisions of the SICA is, however, not over. This is because different State Legislatures have passed what is known as "Relief Undertaking Act", which empowers the State Government to declare a unit as a "relief undertaking", if the State Government is satisfied that it is "expedient so to do in public interest, with a view to enabling the continue running or restarting of an undertaking as a measure of preventing or providing relief against unemployment."[21] Once an undertaking is declared as a Relief Undertaking, the operation of all contracts, assignment of properties, agreements, settlements, awards, standing orders or other instruments in force, is suspended and all or any of the rights or privileges, obligations and liabilities accruing or arising there under also remains suspended or is enforceable with such modifications and in such manner as may be specified in the Notification. The Act further

provides that no suit or legal proceedings shall be instituted or commenced or if pending, shall be proceeded with against the industrial undertaking during the period in which it remains a Relief Undertaking, notwithstanding any law, usage, customs, contract, instrument, decree, order, awards settlement or other provisions whatsoever. The State Government has power to declare any undertaking as a "Relief Undertaking" for a period of one year and the period can be extended to five years. It can thus be seen that the implications of the Relief Undertaking Act, as promulgated in the States of Maharashtra, Karnataka, Gujarat, Rajasthan, Madhya Pradesh, Andhra Pradesh and a couple of other States, is that it gives statutory protections on the lines of Section-22 of SICA and there have been many examples where, in spite of decree being available in their favour, the Banks and FIS have not been able to touch the secured assets. These Acts were promulgated when the "economy was in development mode" and the Sick Industrial Companies Act, 1985, had not come into existence. Now that SICA has been repealed, there is need also to persuade the State Governments to repeal the Relief Undertaking Acts in their respective State.

Impact of Mardia chemicals case:

The Legislative Impact – an Appraisal

The major impact of this piece of legislation over the economy is summed up by the researcher as under.

1. Facilitates creation of markets in financial claims

By creating tradable securities out of financial claims, securitization helps to create market in claims, which would, in its absence, have remained bilateral deals. In the process, securitization makes financial markets more efficient, by reducing agency costs.

Since financial assets are tradable, it also reduces the liquidity risks in the financial system. Liquidity related problems have been responsible for a number of economic crises: recently Japanese crisis and South East Asian crisis. Securitization can help financial intermediaries better manage asset liability mismatches and therefore avert liquidity problems. Result, the need for risk capital that is needed, among other things, for supporting liquidity also comes down.

2. Disperses holding of financial assets

The basic intent of securitization is to spread financial assets amidst as many savers as possible. With this end in view, the security is designed in minimum size marketable lots as necessary. Hence, it

results into dispersion of financial assets. Recent securitization application, viz., mortgage, receivable, etc. are therefore yet to become acceptable to lay investors.

3. Promotes Savings

The availability of financial claims in a marketable from with proper assurance as to quality in form of credit ratings, and with double safety nets in form of trustees, etc., securitization makes it possible for the lay inventors to invest in direct financial claims at attractive rates. This has salubrious effect on Savings.

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Securitization tends to eliminate fund based intermediaries, and it leads to specialization in intermediation function. This saves the end-user company from intermediation costs, since the specialized intermediary costs are service related and generally lower.

5. Diversified risks

Financial intermediation is a case of diffusion of risk because of accumulation by the intermediary of portfolio of in risks. Securitization further diffuses such diversified risk to a wide base of investors, with the result that the risk inherent in financial transactions gets very widely diffused.

6. Focuses on use of resources and not their ownership

Once an entity securitizes its financial claims, it ceases to be the owner of such resources and becomes merely a trustee or custodian for the several investors who thereafter acquire such claim. In this sense, securitization carries Gandhi's idea of capitalist being a trustee of resources and not the owner.

7. Smoothens impact of recession

In 1991, when the US economy was passing through recession, securitization was booming. In the year 2001-2002 the global economy passed through multifarious problems-large bankruptcies, terrorism, etc. However, securitization markets have continued to grow through all this; and the growth has been wide spread across different sectors. Evidently, more money is being raised by credit card securitization than in the past-which means consumer spending is being spending propped by capital markets. More auto loans have

been securitized in 2002 than in the past. All this tends to ease out the impact of economic recession.

The illegalities in the Act:-

The constitutional Validity of the SARFAESI Act was examined by the Hon. Supreme Court is Mardia Chemicals Ltd Vs Union of India. The main challenge to the Act was that the banks and Financial Institutions had been vested one sided and unguided arbitrary powers on the bank to the recover the dues. Besides that that the Act did not provide any appropriate and adequate mechanism to decided dispute relating to the correctness of he demanded, its validity and actual amount due to the banks etc.

Taking into consideration the submission made by the parties, the Supreme Court inter alia framed the following issues for adjudication:

(ii) Whether it is open to challenge the statute on the ground that it was not necessary to enact it in the prevailing background particularly when another statute was already in operation?

(iii) Whether Provisions as contained under Section 10 and 17 of the Act provide adequate and efficacious mechanism to consider and decide the objections/disputes raised by a borrower against the recovery, particularly in view of the bar to approach the civil court Under Section 34 OF THE Act?

(iv) Whether we remedy available Under Section 17 of the Act is illusory for the reason it is available only after the action is taken Under Section 13(4) of the Act and the appeal would be entertainable only on deposit of 75% of the claim raised in the notice of demand?

(v) Whether the term or existing rights under the contract entered into by two private parties could be amended by the provisions of the law providing certain power in one-sided manner in favor of one of the parties to the contract?

(vi) Whether provision for sale on properties without intervention of the court under Section 13 of the Act is akin to the English mortgage and its effect on the Scope of the bar of the jurisdiction of the civil court?

(vii) Whether the provision under Section 13 and 17(2) of the Act are unconstitutional on the basis of the parameters laid down in different decisions of this Court?

(viii) Whether the principle of lender's liability has been absolutely ignored while enacting the Act and its effect?

Considering the points put forward by the parties, the recommendation of Narasimhim Committee, and the changes in the global economy, Supreme Court upheld the Constitutional validity of the Act, stating that in view of the changing Global economy , it may difficult to stick to old and conventional method of Financing and recovery of dues. Further it was held that the condition of pre deposit of 75% of the dues or filing appeal Under (Section17 (2)) was bad rendering the remedy. At this juncture, it would be interesting to quote the following from the judgment.

"The effect of the some of the provisions may be a bit harsh for some of the borrowers but on that ground the impugned provisions of the Act cannot be said to be unconstitutional in view of the fact that the object of the Act is to achieve speedier recovery of the dues declared as NPAs and better availability of capital liquidity and resources to help in growth of economy of the country and welfare of the people in general which would sub serve the public interest".

Role of IBA & Enforcement of Security Interest

IBA is an association of Banks and, therefore, is expected to function as a watch-dog to protect the interests of Banks as lenders. So far as the interests of debtors are concerned, there are umpteen number of Forums, Association of Merchants and Chambers of Commerce to act as agency to persuade the government and legislatures to carry out suitable amendments in the existing laws, by organizing workshops and seminars and based on it, sending their recommendations to various governmental agencies. There is no such forum to take care and highlight the cause of Banks and FIs.. At times, the decisions, affecting adversely to the interests of the Banks, have come and as a result, the whole financial system has faced difficulties. IBA can easily keep a track of these decisions and become intervener in appropriate cases to further the interests of its members.

In this regard, a reference is made to a decision of the Supreme Court in the case of Union Bank of India vs. Manu Narayana.[27] where the Supreme Court held that since a portion of the decrial amount was covered by the mortgage, the decree-holder Bank had to proceed against the mortgage property first and then against the guarantors. This decision of the Supreme Court had upset the well-accepted concept of the "liability of the surety" being joint and several, together with the

principal debtor. Since this decision of the Supreme Court, the Institutions labored had to overcome the situation created by this judgment and it was after a long wait of 5 years that the Hon'ble Supreme Court in the case State Bank of India vs. India Export.[28] held that a composite decree comprising of money decree against the judgment debtors is passed jointly and severally against all the defendants, including the guarantors. Hence, decree holder can execute a decree first against the guarantors without proceeding against the mortgaged property. The Court further held that the observations of the Court (Supreme Court) in Manu Narayana case that "even if the two portion of the decree are severable and merely because a portion of the decrial amount is covered by mortgage decree, the decree holder per force has to proceed against the mortgaged property first, are not based on any principle of law." Thus, the hardship caused by the judgment of the Hon'ble Supreme Court in Manku Narayana case could be rectified only after five years.

Similarly, in Mukesh Chand vs. Regional Branch Manager, UP State Financial Corporation & others.[29] the Supreme Court observed that Section-29 does not exclude the application of the principle of natural justice. Referring to Section-24 of the UP State Financial Corporation Act, they observed that the "Corporation must pay due regard to the interest of the industry, commerce and general public," more so, because the Financial Corporations under the Act, were visualized not as a profit-earning concerns, but "an extended arm of a welfare State" to harness business potential of the country to benefit the common man. It further held that a "helping attitude, on the part of the Corporation, to constantly monitor the working of the industrial concerns would further the object of the Act and the constitutional objective of economic justice to the needy" and on this basis, held that by disposing of the secured assets, the Corporation "acted indifferently and not in public interest". After this judgment, the Financial Corporations felt themselves obliged to confine to the standard that met the test of justness, fairness, reasonableness and relevance and hesitated in taking action under Section-29 of the SFC Act. It was only after the Supreme Court in Haryana State Financial Corporation & anther vs. Jagdamba Oil Mill & another.[30] (2002) 3 SCC 496 that the balance which had tilted in favour of debtor and against the creditor got corrected. The Supreme Court in the above case made the following observations:

"The relationship between the Corporation and the Borrower is that of a creditor and a debtor. Corporation is not supposed to give loan and then write it off and, ultimately, go out of business..... Promoting industrialization does not serve public interest, if it is at the cost of public funds. Grant of loans as also the steps taken towards recovery are administrative action. The extent of judicial scrutiny/judicial review

in the case of administrative action cannot be larger than in the case of quasi-judicial action".

Quite often, the Institutions are not able to defend themselves properly. As a result, the decisions affect the whole system. It is therefore, desirable that forums like Indian Banks; Associations, which are supposed to be working as self-regulatory organization (SROs), should become intervener and further the interest of their own members, so that the pleading in favour of Banks &FIS are properly presented before the Courts and the system is saved from adverse observations of the Courts having systemic implications. Such a step by IBA like Institutions would go a long a way to help the cause of Banks and of the whole financial system.

Suggestions for Improvement:

Effective "Enforcement of security interest" does not depend only on the rights and liabilities as dealt in the TP Act or the Contract Act or SRFA ESI Act. It get adversely affected by various other factors like the concept of Crown debt, Relief Undertaking, conflicts between the provisions of different statutes, etc.

There is need to be equitable, both to the creditors and debtors, but at the same time, path of recovery must be kept clear of obstructions and it is, in this content, that the RBI and its Legal Department can play a very useful role. The Legal Department of RBI is capable of understanding and appreciating the implications of any new statute or amendments or of case laws on the functioning of Banks and Files and can be made to work as a nodal agency for ensuring that road to healthy and efficient financial system is kept clear of all obstructions. On the lines of Chamber of Commerce, there is need for a forum for Banks and Files to act as a watchdog of their interest. In this connection, the IBA can play a very useful role. With the liberalization and globalization of the economy, the protective cover provided by the Municipal Laws and Rules and Regulations framed there under are falling apart. It has now, become incumbent on the part of each of the countries to make its law compatible with similar provisions existing world over. As part of this process, the Reserve Bank of India, as Central Bank of the country and the regulator of its financial system, needs to ensure that the statutes or modifications carried out and law as laid down by Courts, do not impeded generally the functioning of Banks and Financial Institutions and especially the enforcement of security interests. It goes without saying that health of the financial system depends on the money coming back to the system; hence the road to recovery needs to be kept clear of all impediments, all the time.

CHAPTER – VIII

PREVENTIVE MEASURES & LEGAL ACTION

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➢ Banks' Angle

Board of Directors of the banks should be committed and accountable to ensure quality of loan portfolio. Chartered accountants, external/ internal/concurrent auditors should also have accountability for their lapses in the overseeing of loan accounts and overlooking NPAs. Administrative tiers of the banks should be reduced to ensure quick flow of information and timely action in the appraisal, monitoring, follow up and recovery of loans. Accountability of staff should be fixed and reward and punishment be introduced on the basis of performance. Wherever staff accountability is oppressive and inducing loan officers to defer action in a troubled account for fear of vigilance action, steps are to be taken to set right the situation. Banks should approach the NPAs customers rather than wait for them. Banks should ensure that adequate trained and experienced staff is available to effectively administer the credit portfolio. Corruption has to be avoided and ethics and values have to be observed at all levels in handling the credit portfolio. The herd mentality evident in India in the matter of lending to the same category of borrowers/industry results in huge NPAs and has, therefore, to be avoided. To avoid information asymmetry banks should go in for a centralized loan portfolio management. Suggestions have also come to have effective risk management and customer rating systems to improve the quality of credit.

Banks have to develop skills to identify problem accounts early, to intensify reconstruction measures and avoid loss on account of erosion in value of securities. They should concentrate more on standard advances and expedite the measures under corporate debt restructuring mechanism to avoid slippage of accounts into NPAs. In the case of willful defaults, banks have mobilized public/political opinion in their favor and initiate recovery measures. To improve the NPAs position, Shri A.D. Navaneethan former Chairman of Private Sector Bank has suggested that "Conductive recovery climate should be created. Further archaic and rickety legal system has to change. Debt Recovery Tribunal. (DRTs) should be activated and made to play a pro-active role. Rigorous credit appraisal and suitable monitoring mechanism should be in place in all banks. Political interference should be avoided".

NPAs are treated as a banks' problem instead of being treated as a national problem. Timely identification of problem accounts by having a close watch on the standard advances and effective monitoring and follow up can help reduce the problem of NPAs. Some losses on account of NPAs are inevitable in banking business but steps have to be taken to contain them. Bank should introduce stop loss/cut loss limits and have a self built mechanism to ensure self liquidation of, 60 to 70 per cent of the loans automatically. Suitable exit policy for the banks (i.e., freedom to opt out) has to be in place to avoid aggravation of the problem.

- **Borrowers' Angle**

Message should be clear that borrowers cannot remain healthy by making their companies and bankers sick. They also cannot get away with banks funds easily. They have to be made responsible and accountable. Fear through speedy and effective legal system has to be created among them and avoidance of repayment of banks dues has to be severely dealt with.

Some of the suggestions to discourage borrowers from defaulting payment of banks dues include disallowing defaulters from contesting any election or holding any public post. Misuse of banks' funds should be treated as a criminal offence and action be initiated accordingly. Interest debited to the accounts should not be allowed as a deductible expense for income tax purpose, if the borrower has not paid the same to the bank. In the case of defaulters, no fresh credit limit should be sanctioned under any circumstances.

Banks have to ensure that borrowers get right and timely guidance and financial assistance to ensure that their businesses do not suffer. Good corporate governance can be an effective measure in containing the defaults to banks.

- **Suggestions from Government and also Regulatory and Supervisory Angle**

The Government's concern to eradicate the problem of NPAs has to be transferred into a legal system with teeth so that NPAs cases can be disposed off within a short time. Some of the other comments/suggestions include avoiding patronizing appointments of political nominees on banks' boards, and that government should avoid effecting frequent charge in customs/excise duties which affect the viability of the projects because of which the borrowers suffer, resulting in non payment of banks' dues.

➢ Others – General Suggestions

Suggestions have been made to incorporate necessary provisions in the Banking Regulation Act 1949 and Companies Act 1956 to fix accountability on defaulting borrowers. Developing better rapport and improved customer relationship, management, involving representative bodies in the recovery of banks' dues, making the chartered accountants responsible and accountable for fudging of balance sheets, increasing the use of information technology in banks, improving the payment and settlement system, insisting on no-due certificate from banks to avail of income tax concessions and other facilities from various agencies, introducing better transparency standards are the other suggestions given by the respondents to the survey, to contain the NPAs problem.

➢ Summary

The survey has shown that NPAs are caused because of willful default, diversion of funds, deficiency in the credit appraisal standards and lack of supervision and follow up. Opinions indicate that banks are becoming averse to lending and prefer to have safe investments in government securities. Lack of market intelligence system, what of adequate trained staff to supervise the credit portfolio, absence of exchange of credit information among banks re the other major causes of NPAs as per the survey results. There is also a strong opinion that representative bodies like Chamber of Commerce and Industry Federation of Indian Chambers of Commerce and Industry, Confederation of India Industry, etc., do not support banking industry in recovering the dues from their members. As per the ranking on the impact of NPAs on banks, the survey has revealed that erosion of profit and increasing provisions rank very high. Respondents have indicated under specific suggestions to contain NPAs that borrowers have to be made more accountable and responsible. Suggestion also emphasizes good corporate governance to contain the NPAs menace. Survey has indicated sizable percentage of good borrowers not willing to repay and bad performers not willing to repay.

The surveys favor containment of NPAs by intensifying monitoring and follow up of standard advances to avoid slippage to sub-standard categories and below.

Effective Management of NPAs – A Practical Solution

"There is a salve for every sore".[39]

[39] The Wordsworth Dictionary of Proverbs, Wordsworth Editions Ltd., 1993, p.549.

The problem of Non-Performing Advances has been and continues to be a vexatious issue and off and on the Government is called upon to bail out the problem banks using budgetary resources since no Government can remain a hapless spectator and ignore the problem of unmanageable NPAs. Given the Indian Government's limited room for maneuver on the fiscal front, the problem of NPAs needs to be given to priority.[40]

The problem as it stands has been defying solution. Several measures attempted so far based on empirical studies and otherwise, have not yielded positive results either to contain NPAs or prevent them from assuming worrisome proportion or wipe out the problem without affecting banks' profitability or inviting financial support from the government. One of the reasons for ineffectiveness of the measures may be due to focus being overstressed on tackling the problem only from the angle of the lenders and not from the angle of the borrowers, who basically are the cause for Non-Performing Advances after deriving all possible benefits from the banks. Since the problem of NPAs largely emanates from borrowers, it is only appropriate and prudent that solution should also begin from them. NPAs should no more be viewed as a baby of only the lenders and, as such, solution has to be found with the involvement of borrows also. Most lenders do not have a result-oriented strategy at all, as far as problem credits are concerned. This more often compounds the problem and results in delaying or denying solution. A misconception bankers have is the things will somehow get better on their own if they wait. May be cheese, wine and bourbon improve with age but loans don't. Handling problem credits does not benefit from knee jerk reactions either.

The greatest barrier to improving the eventual recoverability of a loan is getting the lender to recognize and that too early, that a credit is in trouble. In spite of both common sense and regulatory reporting procedures, it is not unusual for a lender to believe that a borrower's situation is not bad or at least not as bad as it looks. The next hurdle is convincing the borrower as well, that there is a problem.[41]

Containment of NPAs – International Status

Initiatives taken by a few countries for resolution of NPAs reveal that solution is mainly curative in nature and not necessarily only preventive. The country-wise initiatives are given below in synoptically form.[42]

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[40] The Threat from Banks, *The Business Standard, May 22, 2002.*
[41] Rey Reynolds, What Do I Do When Good Loans Go Bad, *ABA Banking Journal, June 14, 2002.*
[42] Reserve Bank of India, *Annual Report 2001-2002, pp.161 and 165*

1. China :- Supervision and evaluation of the quality of newly extended loans strengthened and responsibility restrained mechanism instituted; Post-lending management given due attention; Special recovery teams established; an evaluation system on recovery of NPLs established; debt restructuring vehicles employed to reduce NPLs.

2. Czech Republic :- Large pars of NPLs of three large state owned banks transferred to the Konsolidacni Banca (KOB)- a government facility created to manage and recover distressed assets; in the pilot phase of the project, KOB auctioned NPLs worth US$500 million; a number of legal reforms including a revised Bankruptcy Act introduced; the state owned revitalization agency selected eight large industrial companies for organizational and financial restructuring.

3. Japan :- Non-Performing Loans (NPLs) sought to be resolved within a period of three years; measures to enhance and intensify the final resolution of NPLs include introduction of special inspections to improve banks; self assessment of their asses, besides enhancement of the functions of the Resolution and Collection Corporation.

4. Kenya :- A Credit Reference Agency where banks can exchange information on the bad borrowers constituted; initiatives taken to improve the judicial system; proposals made to form a NPAs Recovery Trust to take over NPAs from the banking system.

5. Korea :- Large amounts of NPLs sold to Korean Asset Management Company; FLC system which evaluates companies' ability to redeem debt in the future and deal with NPLs, introduced and extended; a corporate restructuring vehicle introduced to expedite NPL resolution.

6. Mexico :- Large volumes of NPLs transferred to the Central Bank to exchange of Government bonds.

7. Pakistan:- Banks and NBFIs required to provide for rescheduled/ restructured loans/advances for a period of one year; banks have been directed that the decision to write-off bad loans may be made by their Boards; due diligence (on prescribed lines) be carried out before write-off proposal is put to competent authority; the

Corporate and Industrial Restructuring Corporation has been established to restructure. Liquidate NPLs of Private Sector Banks.

8. Thailand:- Thai Bankruptcy Act amended in 1998 and again in 1999; a legal regime for Court controlled Corporate Debt Restructuring Agency has been set in place; guidelines for out-of-court debt restructuring modeled; a binding framework in the form of Debtor-Creditor and Inter-Creditor Agreements formulated to encourage Corporate Debt Restructuring; emergency decree on Thai Asset Management Company promulgated on June 9, 2001.

9. United States of America :- In USA during the savings and loans crisis (1989), a single Asset Management Corporation was established to purchase NPLs from a number of banks.

➢Suggestion Proposed for containing NPAs in India

A futuristic approach to solving the menace of NPAs is being suggested here, which is totally different from the traditional methods so far attempted. Hence, acceptance of the solution may require conviction on the part of borrowers, lenders and authorities. The idea needs to be promoted so as to facilitate its acceptance and willingness to adhere to it, particularly among the borrowers. The solution proposed will certainly prove to be advantageous and beneficial for banks, government, owners of banks, borrowers, depositors and all other stakeholders in the long run.

NPAs initially become the banks' burden but gradually the burden of the financial system and then the burden of the economy. Implications of NPAs are reflected in the shrinking bottom line and eroding balance sheets of banks. He problem characterized by erosion of assets and liquidity also affects owners, depositors, employees, good borrowers, general customers, general public and the economy. The borrowers who fail to repay the banks' dues virtually turn out to be very wise in the whole game of banking. It, if left unchecked, may lead to loss of public confidence and systemic risk. Though volumes have been written suggesting ways and means to mitigate the problem and several administrative and legal measures have been initiated in that direction, solution seems to be elusive and turns out to be a mirage-chase.

It will be observed form the data given in Chapter 3, that there is an increase in the NPAs level to the tune of Rs.1, 800 cores every year, registering a growth of 5 per cent in respect of Private Sector Banks. NPAs arise out of standard advances and get classified as sub-standard, doubtful and loss advances depending on the record of recovery, servicing of interest/repayment of principal, extent of irregularities (in

the case of running accounts) and availability of securities, margin money, etc. Once the borrowal account is classified as NPA, the whole burden is shifted to the bank and the borrower behaves as if he is innocent and not concerned at all. The borrower does not realize that because of his default, other good borrowers and stake holders are the sufferers and that finally the bank has to be bailed out through budgetary support, the consequence of which ultimately affects the general public, particularly the tax payers. The government has so far contributed Rs.20, 446 crore towards strengthening the capital of Public Sector Banks to meet the erosion caused by NPAs and there are still more demands from banks for such additional resources. Incidentally, the legal system has to share part of the blame for the borrowers' failure to pay their dues to the bank. It does not require a strong law to enforce that money borrowed from a public institution or for that matter from anybody has to be repaid in any event. It should be as simple a law as possible and public have only to be enlightened on the consequences of non-repayment of borrowed funds from public institutions. Unfortunately, neither our legal system nor the ethics of the borrowers favor the public institutions, which are made to suffer and the burden of cost ultimately falls on the general gullible public.

To save the situation, the only workable solution seems to be to bind the borrowers with an obligation to bear the main burden of NPA. Banks also will have share the burden to some extent to involve themselves and be more vigilant in the overall administration of credit portfolio. It is in this context that a simple and effective model is suggested to solve this perennial problem. The solution shown in the model is practicable and implementalable both from the angle of accounting and legal aspects. Ethically, the solution is acceptable and justifiable as the cost of NPAs is ultimately to be borne by the borrowers, who are the main cause and partially by bankers.

In the long run, the measures suggested should help prevent formation of fresh NPAs and in case some NPAs are unavoidable, the ultimate impact of NPAs should be borne by the borrowers themselves.

- **Statistical Model**

A statistical model projecting future scenario of advances, standard advances and NPAs, on the basis of time series for the past 9 years, has been developed using regression analysis. Two scenarios of future formation of NPAs have been projected to provide a choice for banks to estimate a realistic position of NPAs taking into consideration the efforts that the banks have made/have been making, to contain the level of NPAs. The two scenarios are illustrated in Case I and Case II.

Table 1

Projections of Gross Advances, Standard Advances and NPAs

31st March	Gross Advances	Standard Advances	NPAs
1993	169340.0	130087.0	39253.0
1994	165621.0	124580.0	41041.0
1995	197352.0	158967.0	38385.0
1996	231321.0	189660.0	41661.0
1997	244214.0	200637.0	43577.0
1998	284971.0	239318.0	45653.0
1999	325328.0	273618.0	51710.0
2000	380077.0	326783.0	53033.0
2001	442134.0	381360.0	54773.0
2002	441496.4	385222.9	56178.8
2003	475565.5	417133.9	58323.8
2004	509634.6	449044.9	60468.8
2005	543703.7	480955.9	62613.7
2006	577772.8	512866.9	64758.7
2007	611841.9	544777.9	66903.7
2008	645911.0	576689.0	69048.6
2009	679980.1	608600.0	71193.6
2010	714049.2	640511.0	73338.6
2011	748118.3	672422.0	75483.5
2012	782187.4	704333.0	77628.5

Gross Advances – Intercept = 100805.4 and Trend = 34069.1
NPAs-Calculated on the basis of annual growth observed from 1993 to 2001

Case I

Trend analysis based on actual absolute figures of advances, standard advances and NPAs for the period from 1993 to 2001, using regression analysis, has been estimated for the next 11 years i.e., up to the period ending March 2012. The projection of NPAs has been made for 11 years so that the interest payable by the bank on the proposed reserve can be worked out of 10 years, as there is one year time lag for calculation of interest. In this projection, weight age is given to the absolute growth of NPAs, ignoring the statistical relationship between growth of NPAs and advances. The independence of advances and NPAs has been given weight age as the absolute growth in advance and absolute growth in NPAs have been observed to be maintaining a separate liner relationship. The deficiency in this type of projection partially ignores the declining trend observed in the NPAs as percentage of gross advances. According to this scenario, NPAs are projected to grow in future at an annual rate of around 5 per cent as per the past trend. Accordingly, the NPAs level as

at end March 2012 would work out to Rs 77,628.5 crores as against Rs 54,773 crores as at end March 2001 and NPAs percentage of gross advances will work out to 9.9 per cent in March 2012 as against 12.4 per cent in March 2001. The projection are given Table I.

Case II

In this scenario, NPAs have been projected keeping the statistical relationship of NPAs with gross advances. As the percentage of NPAs to gross advances has been showing a declining trend (declined from 23.4 per cent in 1993 to 12.4 per cent in 2001), projection for the future years has been made reflecting the declining trend, thereby giving credit to banks for their efforts in containing the NPAs. However, the declining trend may be maintained up to the year 2007, wherein NPAs as percentage of gross advances is kept around 5 per cent, as per the recommendations of both the *Tarapore Committee on Capital Account Convertibility* and the *Narasimham Committee on Banking Sector Reforms.* The plateau at 5 per cent is then projected to be maintained thereafter up to the year 2012 keeping in view the limitations of banks in containing NPAs beyond a point and the inevitability of living with NPAs in the fast changing economic scenario with structural deficiencies such as loopholes in the legal system. As per Table 2, the NPAs are projected to be at Rs 40,572 crore as at end March 2012, which are lower than the level obtaining at Rs 54,773 crores as at end March 2001. it is also to be recognized that in this period the gross advances would certainly by increasing in absolute term considerably (almost doubling) making the need for reduction in the NPAs even more significant.

This is likely to be the future scenario of NPAs. What can be the solution for this? To effectively manage and contain NPAs, the present study proposes creation of a fund named 'Precautionary Margin Reserve' (PMR) by levying a small percentage ranging between 0.10 per cent and 0.75 per cent on the standard advances. For this purpose, the standard advances can be classified into four categories viz., A, B, C and D as under.

Standard Advances sub-classification	Levy suggested
(A) Advances which are excellent	0.10 per cent
(B) Advances which are very good	0.25 per cent
(C) Advances which are good	0.50 per cent
(D) Advances which are satisfactory	0.75 per cent

Table 2

Projections of Gross Advances, Standard Advances and NPAs

31st March	Gross Advances	Standard Advances	NPAs
1993	169340.0	130087.0	39253.0
1994	165621.0	124580.0	41041.0
1995	197352.0	158967.0	38385.0
1996	231321.0	189660.0	41661.0
1997	244214.0	200637.0	43577.0
1998	284971.0	239318.0	45653.0
1999	325328.0	273618.0	51710.0
2000	380077.0	327044.0	53033.0
2001	442134.0	387361.0	54773.0
2002	441496.4	393505.7	47990.7
2003	475565.5	430600.8	44964.7
2004	509634.6	468660.0	40974.6
2005	543703.7	507683.3	36020.4
2006	577772.8	547670.8	30102.0
2007	611841.9	579964.9	31877.0
2008	645911.0	612259.0	33652.0
2009	679980.1	644553.1	35427.0
2010	714049.2	676847.2	37202.0
2011	748118.3	709141.3	38977.0
2012	782187.4	741435.4	40752.0

Gross Advances – Intercept = 100805.4 and Trend = 34069.1
Gross NPAs- Calculated as percentage of Gross Advances

Note: The declining trend shown by the NPAs as percentage of Gross Advances is maintained till it reaches a level of approximately 5 per cent (in 2007) as envisaged by Tarapore Committee on Capital Account Convertibility (1997) and endorsed by Narasimham Committee on Banking Sector Reforms (1998). This percentage has shown the trend with intercept = 25.02 and Trend = -1.415.

Classification of standard advances into four categories viz., A, B, C and D, as referred to above, has to be done on a scientific basis ensuring, inter alia, continuous relationship between the banker and the borrower and transparency in their dealings. The element of subjectivity has to be eliminated/ minimized while classifying the advances, which may necessitate making their written consent while finalizing the terms and conditions of the loan at the time of sanction. All standard advances appearing in the balance sheets as on 31st March have to be necessarily classified into these four groups. The parameters for classification of advances can be strictly on the basis of performance of borrowers. The present risk management techniques using Altman's Z score Model, Credit Matrix, Credit Risk, KMV and other Credit Risk Models can be suitably factored into, to arrive at the sub-classification of standard advances. The levy should have legal sanction which can be ensured by banks entering into contract with all existing and new borrowers Banking Regulation Act for such classification and levying of charges.

Initially all new borrows have to be classified under category A and over a period, based on their performance, they have to be categorized under A, B, C and D. Parameters for classification have to be left to the judgment of the respective banks as some of the Public Sector Banks are already doing well and some are performing very badly. However, the broad parameters can be:

i) Character, competence, credit worthiness of the borrower based on market intelligence report and banks' own experience.
ii) Internal credit rating if any given by banks to borrowers.
iii) Conduct of accounts covering, inter alia, tendency to overdraw the account frequently, diversion of funds, not falling under credit discipline, non-adherence to the terms and conditions of loan sanctioned, failure to respond to bank's requests calling for certain financial statements or information.

The existing borrowers also have to be classified as per banks' judgment based on past performance and after entering into agreement with them for such classification and levying of charges.

The levy suggested in the range between 0.10 per cent and 0.75 per cent, has to be debited to the borrowers' account and the credit should go to Precautionary Margin Reserve Account to be maintained under the liability side the balance sheet. This account should be shown distinctly separate from various other reserves under the column reserves and surplus of the balance sheet. The levy is in the nature of a guarantee fee collected in advance from all borrowers as on 31st March every year against possible default at a later stage. Since the concept discussed above is innovative and does not fall under the present established Accounting policies of the bank, the need for introduction of such a concept in the interest of stability of banking system, protection of depositors' interest and overall benefit to the financial system, economy and the government deserves consideration and proactive response on the part of the banks and the regulator. Since this concept justified the prudence, substance over form and materiality referred to in the Disclosure of Accounting Policies[43] there should not be any problem for implementation with proper transparency standards. Besides, since banks are governed by the Banking Regulation Act 1949, there should not be any objection in introducing this concept by the Reserve Bank of India by invoking the enabling provisions under Section 5 (Ca) and 21 of the Act.[44] Section 5 (Ca) relates to banking policy which means any

[43] A. Ramaiah, Guide to Companies Act, Statements and Standards on Accounting as Issued by *ICAI AS-I, 2001, p.5123.*
[44] Tannan's, Banking Law and Practice, Chapter 3, BR Act 1949, Indian Law House, New Delhi, 20022, pp.90-91.

policy which is specified from time to time by the Reserve Bank of India in the interest of the banking system or in the interest of the monetary stability or sound economic growth, having due regard to the interest of the depositors, volume of deposits and other resources of the bank and the need for equitable allocation and the efficient use of these deposits and resources.

Section 21 of the Banking Regulation Act which provides adequate power to the Reserve Bank of India to control advances by banking companies states that:

1. Where the Reserve Bank is satisfied that it is necessary or expedient in the public interest or in the interest of the depositors or banking policy so to do, it may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular and when the policy has been so determined, all the banking companies or the banking com. Concerned, as the case may be, shall be bound to follow the policy as so determined.

2. Without prejudice to the generality of the power vested in the Reserve Bank under sub-section (1), the Reserve Bank may give directions among other things to banking company or group of banking companies in particular, as to the rate of interest and other terms and conditions on which advances or other financial accommodations may be made or guarantees may be given.

3. Every banking company shall be bound to comply with any directions given to it under this Section.

In the case of off-balance sheet items viz., forward exchange contracts, guarantees and acceptances, endorsement, etc. the levy can be made @ 1 per cent and more (depending on the credit worthiness of the borrower) as and when the liability crystallizes and forms part of standard advances. This percentage can further be increased suitably depending upon the classification of standard advances viz., A, B, C and D. It is worth noting in this context that Public Sector Banks hold a huge volume of off-balance sheet exposures (Rs 2, 98,375 crores as on March 2001) and a portion of these gets crystallized and form part of NPAs.

The classification of standard advances into four categories as mentioned above and levy proposed against each classification towards Precautionary Margin Reserve and the interest at 6 per cent per annum compounded annually and payable by the bank on such Reserves are given separately for both the cases under Table 3 and 4 over a period. Through theses small levies, banks would be in a position to command a

sizeable amount. Rte of interest has been assumed at 6 per cent, taking into consideration the expected reduction in Bank rate from 6.5. to 6 per cent by Reserve Bank of India through its credit policy. The rate is expected to prevail for some years to come on the assumption that the real rate of interest, i.e., the difference between nominal rate of interest and inflation will be maintained in the range of 2 to 3 per cent. The inflation rate has been in the range of 3 per cent and 4 per cent and the Bank rate is expected to be brought down to 6 per cent. An inflation of 3 per cent to 4 per cent is estimated to be reasonable for ensuring a reasonable economic growth and as such the assumption of 6 per cent is taken as being stable for another 10 years to come. In case the Rate of increase, the benefit will accrue to the Fund, and the bank will also not lose much. In case, the Rate comes down, the building up the reserves will take a longer time and still the benefits accruing from the reserves will be considerable. Refer Tables 3 and 4.

The advantages that accrue from the Model to the banks can be in the form of automatic mobilization of resources on a recurring basis as on March 31 every year, relatively at a cheaper cost. This will help to enhance the balance sheet size and ensure availability of funds on a dependable basis. This Fund can be treated as substitute for subordinate debt thereby enabling the bank to save on interest cost and future recurring liabilities. Loss at present incurred by banks by way of opportunity cost on account of NPAs (refer Table 3 and in Chapter 2) would get substantially narrowed/ eliminated over a period. Creation of such a fund can bring discipline and efficiency in the administration of credit and can help in improving the profitability of banks in the long run as charges at present debited to profit and loss account @ 0.25 per cent on standard advances towards provisions can be dispensed with the present aversion to lending will get reversed gradually and credit at a reasonable cost will pick up. The rating of banks will get improved on the strength of strong balance sheet position and better market reputation. Dependence on government for financial support can be totally voided. Once the climate on NPAs improves, the overall culture particularly the credit culture in banks will change for the better and the benefits that accrue to the financial system and the economy will be enormous.

As far as government is concerned, there may not be any occasion in future to bail out the banks because of their weak position on account of NPAs. The funds accumulated with the banking system will be adequate enough to strengthen the balance sheets of banks. Banks will have to cultivate a new professional approach. Return on investments will improve both on dividend and taxation account. Strong banking and financial system, which are said to be a reflection of the economy, can help the economy grow faster and stronger, bringing all round benefits.

The moral hazard that a virtual certainty of bailouts encourages financial intermediaries to approach the government for support for comfort can be totally eliminated once this Fund is set in operation. Finally government will have the satisfaction of setting up certain standards for improved performance of banks, borrowers, the financial system and the economy literally free of cost.

The Model can bring greater benefits to the borrowers in the long run. While the Model will enforce discipline in the conduct of loan accounts with banks, it can improve habit of thrift among reckless borrowers. Such an arrangement ensures continuous and emotional rapport with bankers and takes care of their genuine financial problems. Being disciplined borrowers; their rating and market reputations will change for the better. Apart from enjoying funds at lower cost in the long run, borrowers can hope to get due recognition and incentives/ rewards for excellent conduct of banks accounts. All these can be derived at an insignificant cost.

The Model suggested has been tested with reference to the past figures from 1993 to 2001 of Public Sector Banks and the results are indicated in Table 5.

Assumption Made in the Model

1. Standard advances have been sub-classified into four categories A, B, C and D based on their performance, conduct of accounts, market intelligence report, adherence to the terms and conditions of loans sanctioned their attitude towards clearing the banks' dues, etc. Amounts distributed @ 25 per cent under each group on the assumption that bank's advances portfolio has been well managed and as per standards set for classification, each group will not have more than 25 per cent of standard advances.

2. Recovery towards 'Precautionary Margin Reserve' has been made @ 0.10 per cent for category A (i.e. 10 paise for Rs 100), @ 0.25 per cent for category B (i.e. 25 paise for Rs 100), @ 0.50 per cent for category C (i.e. 50 paise for Rs 100) and @ 0.75 per cent for category D (i.e. 75 paise for Rs 100). Banks can have different percentages depending on the strength of their credit portfolio and rapport with borrowers. This shall be done with the consent of borrowers and should form part of the contract between the lender and the borrowers.

3. In Case I and II interest @ 6 per cent p.a. on cumulative basis has been assumed to be provided for by the banks on the Precautionary Margin Reserve, as bank's contribution towards this

fund. This is suggested to ensure banks involvement in sharing the burden on account of NPAs and the fund would, therefore, be managed with better discipline and care.

4. In Table 5 the interest rate @ 7 per cent has been assumed keeping in mind, the overall average cost of deposits for the banks on a conservative basis. The rate of interest was on the high side in early 1990's

It will be observed from the Table 5 that, had the banks implemented the suggestion with retrospective effect from 31st March 1993, they would have amassed a sum of Rs 10,138.3 crores as on 31st March 2001. This is almost 50 per cent of the amount (Rs 20,446 crores) so far contributed by the Government towards bailing out banks and 20 per cent of the gross NPAs (Rs 54,773 crores) of Public Sector Banks.

Non Performing Advances and PMR

The position of NPAs and PMR as of 2012 (for PSBs as a whole) as per the Model suggested under the two scenarios referred to earlier (Case I and II) is furnished below:

Case I

NPAs : Rs 77,628.5 crores
PMR : Rs 31,518.5 crores

Case II

NPAs : Rs 40,752 crores
PMR : Rs 33,159 crores

It will be seen that in Case I (when NPA projections are based on absolute /autonomous growth) PMR will accumulate to Rs 31,518.5 crores as against the estimated NPAs of Rs 77,628.5 crores. Similarly in Case II, where NPAs are estimated as percentage of gross advances and keeping a tolerable level of 5 per cent, the PMR will accumulate to Rs 33,159 cores, as against the NPAs of Rs 40,752 crores, as at the end March 2012. It may be seen that there is a gap between formation of NPAs and accumulation of the proposed reserves, amounting to Rs 46,110 crores and Rs 7,593 crores under Case I and Case II respectively (details in Table 6). The gap will get considerably narrowed/reconciled if banks can provide in. at additional rate (as they will be exempted from making provision at the rate of 0.25 per cent on standard advances as per the suggestion in the model) or can go in for a suitable levy on advances arising out of crystallization of non-fund based business. This

➢ *Summary*

Erosion is seen in values and ethics in the society. Expecting borrowers to repay the banks' dues without force/compulsion or an inbuilt catch in the system would be altruistic. While banking system has to play the key role of intermediation between depositors/savers and borrowers/investors, its continued viability is a must and cannot certainly be linked to the support from government. A bank are run on public trust and their own trust on investors/borrows. There are no shortcuts to ensure confidence and viability other than strengthening the balance sheets of banks by involving the borrowers who are ultimately the major beneficiaries of baking. Since the problem requires both preventive and curative measures, banks are advised to intensify measures and try to recover as much as possible to bring down the accumulated NPAs. The model suggested is of preventive nature and earlier the banks introduce this concept, the better. Any economic activity by definition has an element of risk. And defending yesterday-that is not innovating-is far more risky than making tomorrow.[45] Simultaneous application of both curative and preventive measures can improve the credit culture. The ultimate objective of any credit administration is to ensure quality assets and it has to be realized in this context that quality is never an accident; it is always the result intention, sincere effort, intelligent direction and skilled execution; it represents the wise choice among many alternatives.[46]

Any financial system that works on a net profit of 0.33 per cent and a gross NPA level of over 12 per cent cannot sustain for long. The adages 'prevention is better than cure' or 'a stitch in time saves nine', hold good in the monitoring of credit portfolio and arresting fresh generation of NPAs and are equally important in the context or recovery of NPAs. In banking system, some NPAs are inevitable and cannot be totally eliminated. What needs to be done is to arrest fresh accretion and contain it to the barest minimum by preventing slippage through effective proactive steps and that too at the right time.[47]

Nothing can motivate a banker more today than effective NPA management. If NPA recovery rate is high, further disbursement would be automatically high. An effective monitoring and control aided by proper legal reforms would change the contours of NPA in Indian Banking on par with international standards and build resilience for a

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[45] Peter F. Drucker, Practice and Princples-The Practice of Innovation, *Innovation and Entrepreneurship*, UBS Publishers and Distributors Ltd., 195, p.124.

[46] K. Shama, Hand Book of Management quotes, Ben Johnston Publishing Company, New Delhi. P.43.

[47] Ranjaa Kumar, NPA Management for Better Banking, Proceedings of the Bank Economists Conference 2000, Banking in the New Millennium, pp.68-73.

stronger and vibrant financial system to realize the objectives of the reform measure implemented so far.[48]

"A mutually beneficial business relationship can be forged only on the basis of truthfulness and reciprocity:

... Yajurveda 3/49

Lenders and borrowers have to reinvent their relationship and have to be proactive and dynamic for the betterment of both.

[48] Ibid.

CONCLUSION

The Administration of Financial Resource and the Development of an economy are directly depended on the deployment of available funds by Banks and Financial Institutions. Therefore any stress and strain in an economic system will reflect upon the banking Industry. The circulation of money in the economy is facilitated through the large network of banks spread all over the country. In India the banking system has been playing this important role since its introduction in to the economy. Apart from that the banks in India have been prompt and responsive in addressing the social needs of the people. In the recent years Indian Banks are weighed down by enormous amount of bad debts, which threatened the very health of the banking system.

With the Introduction of prudential norms of income recognition, the banks had classified unproductive accounts as Non-Performing Assts which constitute a real economic cost. The NPAs reflect the application of scarce capital and resources for unproductive purpose. The locked up NPAs is neither available for productive redeployment nor any income is generated by it. It affects the credit rate and image of the bank as well as the capacity to raise low cost resources. The banks in India have taken a number of steps to eliminate the NPAs which have been discussed in detail in this thesis. But still there is further scope for refining the credit risk Management and decision making process with modern management tools.

The Lok Adalat has proved to be a very good agency for Quick Justice and speed recovery of smaller loans. The reserve Bank of India has come up with the scheme of one time settlement (O.T.S.) to deal with loans

with higher outstanding. The O.T.S. has proved to be very effective and the Public sector Banks could affect substantial recovery.

If the laws are made more effective and disposal of suits and applications are made faster, the situation will improve considerably. The legal procedure shall be simplified and the Judicial Officers also be positively made aware of the situation. The institutions like DRTs must be provided with adequate staff and the infrastructure to make effective recovery. The courts and Tribunal must be granted enlarged discretion to decide the cases from the basis of equity also.

As the present study is a critical examination of the existing legal mechanism, it would be advisable to sum up the discussion with a summary of available options / mechanism under present day legal system.

RECOVERY OPTIONS AVAILABLE IN INDIA

AGENDA

- **Civil Suit**
- **Summary Procedure**
- **Foreclosure suit on Mortgage**
- **Criminal Actions**
- **Winding up of Company**
- **Debts Recovery Tribunal**
- **Section 138 of Negotiable Instrument Act, 1881**
- **SARFAESI**

Recovery Options – Civil Suit

- Civil Suit
- (In case of Banks and Financial Institutions where outstanding is below Rs.1.00 Million)

- Civil remedy
- by filing a civil suit under Section 9 of Civil Procedure Code, 1908
- the court may appoint Court Receiver, Attachment before judgment, Injunction, giving surety/security, depending upon the facts and circumstances of the case.

Recovery Options – Summary Procedure

- *Summary Procedure*
- *(In case of Banks and Financial Institutions where outstanding is below Rs.1.00 Million)*
  - *Filed under Order XXXVII of Civil Procedure Code, 1908*
  - *For recovery of certain types of debts the following classes of suits namely:-*
    - *suits upon bill of exchange, hundies and promissory notes;*
    - *on a written contract*
    - *on an enactment*
    - *on a guarantee.*
    - *Getting an early decree is possible*

Recovery Options- Foreclosure suit on Mortgage

- *Foreclosure suit on Mortgage*
  - *Order 34 Rule 11 of Civil Procedure Code, 1908 deals with mortgage suits*
  - *In case of banks and financial institution where outstanding is more than Rs.1.00 million, DRT's don't make such distinction.*

Recovery Options- Criminal Actions

- Criminal Actions
  - Where a borrower has, misutilised the loan proceeds or sold the financed assets or obtained the finance by fraudulent means.
  - Criminal actions can be initiated under sections of Indian Penal Code.
- 420 (cheating)
- 406 (criminal breach of trust)
- 465 (forgery)
- 403 (misappropriation of property)

- More of a deterrent effect

Recovery Options – winding up of Company

- Winding up of Company
- If a company doesn't pay despite demand, action for winding up of the company is initiated.
- Notice under section 434 of Companies Act to be served.
    - before resorting to winding up petition.
    - notice under section 434 of the Companies Act is to be served
    - on the debtor company

Recovery Options - DRT

- Debts Recovery Tribunal
    - Bank or financial institution or a consortium of banks can file cases before DRT
    - if the amount of debt due is more than Rs.1.00 Million.
    - In any event the Civil Procedure Code, 1908 is not applicable
    - Modes of recovery of debts are
- attachment and sale of properties both movable and immovable,
- arrest of the defendant and his detention in prison,
- appointing a receiver for the management of the properties.

Recovery Options- Section 138

- Section 138 of Negotiable Instrument Act, 1881
    - Dishonor of a cheques is made punishable offence under section 138 of Negotiable Instruments Act, 1988
    - Notice to be issued.
    - By obtaining post dated cheques (PDC) towards repayment, the Lender can initiate action u/s 138.

Recovery Options- SARFAESI

- SARFAESI
- Without the intervention of court or tribunal, secured assets can be enforced by the Lender.
- Within 60 days notice period to be issued.
- A notice should be issued by the secured creditor under a security agreement, where any borrower makes any default in repayment of secured debt or any installment.

- In case the borrower fails to discharge his liability in full within the period of sixty days, the secured creditor
- may take possession of assets and
- sell them
- towards its dues
- For the remaining dues if any, Lender can file case before DRT.

<u>APPENDIX-I</u>

HIGHLIGHTS OF NARSIMHAM COMMITTEE REPORT ON THE FINANCIAL SYSTEM

The Government of India appointed a Committee under the Chairmanship of Shri.M.Narsimham to examine all aspects relating to the structure, organization, functions and procedures of the financial system. The Deputy Governor, Reserve Bank of India(Banking Operations),Chairmen of State Bank of India, IDBI, ICICI, Shri Manu Shroff, Shri Y.H.Melegam, Shri Mrinal Datta Chaudhari and the Additional Secretary(Banking)were the members of the Committee.The various functions entrusted to the Committee were as follows:

(I) Examination of the existing structure of the financial system and its various components and to make recommendations to improve the efficiency and effectiveness of the system with particular reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions.

(II) Recommend measures for improving and modernizing the organizational systems, procedures and managerial policies.

(III) Recommend measures for infusing greater competitive vitality into the system, so as to enable the banks and financial institutions to respond more effectively to the emerging credit needs of the economy.

(IV) Examination of the cost, composition and adequacy of the capital structure of various financial institutions and to make recommendations in this regard.

(IV) Review relative roles of different types of financial institutions in the financial system and to make recommendations for their balanced growth.

(V) Review the existing supervisory arrangements relating to various entities in the financial sector and to make recommendations for ensuring appropriate and effective supervision.

(VI) Review existing legislative framework and to suggest necessary amendments for implementing the recommendations.

APPENDIX-II

SLOGANS ON NPA MANAGEMENT

1. Proper Monitoring – Protects our Profits
2. Double your NPA Recovery to Redouble our profits.
3. Less NPA More Profits-Make your Banking a Pleasure.
4. Kill NPA lest it will kill you
5. Market OTS –it is a Sure Fire One Time Solution for Recovery
6. Recovery- No Respect
7. Recover and Relax
8. The Action Word-Rehabilitate or Recall
9. Boys can lend but Bankers can only recover.
10. Prevention is better than cure—the best way to manage NPA is to prevent it.
11. Pay your dues today and avail of a loan tomorrow
12. NPA Management-Proactive and not reactive
13. Take the Compromise route with confidence and Reduce NPA.
14. Recover or Perish.
15. Perform or Perish.
16. Depositors make our business Possible
    Borrowers make it profitable.
    NPA's make it Perishable.

APPENDIX-III

SUPREME COURT'S DECISION IN THE CASE OF MARDIA CHEMICALS LIMITED

The Supreme Court pronounced its judgement in the case M/s Mardia Chemical Ltd. vs. Union of India and others, etc. etc .on 08.04.2004.

The Supreme Court has – (i) upheld the validity of the SARFAESI Act, - (ii) struck off the provisions of Section 17(2) of the Act and – (iii) directed that any reply made/objections raised by the borrower in response to the notice given under Section 13(2) of the Act should be considered and **the consideration should be a meaningful one with due application of mind and the objection should not be rejected ritually. The reasons for not accepting the objections or points raised in reply, however brief they may be, must be communicated to the borrower.** *The reasons so communicated shall only be for the purposes of the information/knowledge of the borrower without giving rise to any right to approach the DRT under Section 17 of the Act, at that stage.*

In the circumstances, the following course of action shall be adopted in dealing with the objections raised by the borrower in response to the Bank's demand notice under SARFAESI Act:

- For issuing demand notice under Section 13(2) of the Act, action shall be taken as per procedure detailed in the Bank's Manual on Enforcement of Security Interest.

- **If borrower sends reply/objections to the notice sent by the bank, the same shall be considered. The reasons for not accepting the objections or points raised shall be communicated by the Authorized Officer. It shall be ensured that such communication has been received by the borrower.**

- The reply shall be made out after full consideration of facts and shall be got vetted from Law Officer/Manager(Law) at RO/ZO

- Where the reply of the borrower brings out complex issues, the matter may be brought before the Committee of Officers, and line of action and reply can be sorted out/decided. The Committees of Officers have been constituted at various levels in terms of Resolution No. 68 dated 28.10.2002 of the Board of Directors of the bank. Their constitution and functions were advised vide PAD Circular 10/2002 dated 17.10.2002.

- Only Authorized Officers shall send/communicate the reasons for not accepting the objections, if any, raised by the borrower or send any other communication to the borrower with regard to notice sent under Section 13(2) of the Act or the reply received from the borrower to such notice.

- If no reply/objections are received, or if the reply/objections received have been considered and reasons for not accepting the objections or points raised have been communicated, further steps under Section 13(4) of the Act shall be taken as per guidelines given in the Bank's Manual on Enforcement of Security interest.

- If, after any measures under Section 13(4) of the Act have been/are taken, the borrower files, under Section 17 of the Act, an appeal before DRT against the measures taken under section 13(4), the matter shall be contested appropriately. If any application for stay of further proceedings by the Bank under Section 13(4) is moved, the same shall be opposed effectively having regard to the facts and circumstances. For this purpose, the counsel engaged shall be briefed thoroughly for arguing effectively in the matter. If, for any reason a stay order is likely to be passed by DRT, effective arguments shall be made so as to enable DRT to pass a conditional order.

- In cases where notices under Section 13(2) have already been served and if the borrower has sent any reply/objections, then irrespective of whether any measures under Section 13(4) have been taken/are to be taken, the reply/objections sent shall be considered and reasons for not accepting the objections or points raised shall be considered and reasons for not accepting the objections or points raised shall be communicated in all cases as per procedure given above.

- There is no time-limit fixed for sending rejoinder to reply/objections to notice. It is in Bank's interest to send the rejoinder/reasons for not accepting the objections/points raised in borrower's reply expeditiously. Only after communication of such rejoinder further action shall be taken.

- If reply received from the borrower does not spell out any objections or does not raise any points, instead it reads such as 'thank you for the notice', 'I acknowledge the receipt of the notice' or 'I am making efforts to repay the dues' etc., such reply requires **no rejoinder.** If the reply as received provides an opportunity to call the borrower for a discussion, this may be done to find out the available alternatives.

Thus, the Authorized Officer Shall take stock of the matters dealt with under SARFAESI Act , and do the needful on the following action points:

(A) Matters where notice under Section 13(2) has been given and measures under Section 13(4) are yet to be taken.

It be checked up whether the borrower has sent any reply/objections to the notice sent by the bank. If reply/objection is received, it be checked up whether the same has been considered and reasons for not accepting the objections or points raised have been communicated to the borrower.

If no reply is received, the bank may further proceed to take measures under section 13(4) of the Act.

If before taking any measures under Section 13(4),reply/objections are received, the same be considered as per procedure given above and the response to the reply be given.

If, upon taking measures under Section 13(4) of the Act, the borrower files appeal before DRT under Section 17 of the Act, the matter be contested appropriately. If any application for stay of the further proceedings by the bank under Section 13(4) is made, the same be opposed, having regard to the facts and circumstances. For this purpose, the counsel engaged be briefed thoroughly. If, for any reason a stay order is likely to be passed by the DRT, effective arguments be made so as to enable DRT to pass a conditional order.

B) MATTERS WHERE MEASURES UNDER SECTION 13(4) HAVE BEEN TAKEN:

If the borrower has given any reply/objection, the same be considered and reasons for not accepting the objections or points raised be communicated as per procedure given above.

In the absence of any response/reply from the borrower, further steps be taken for sale of the asset taken possession of, or any other steps as may be required under section 13(4) of the Act.

If, upon taking measures under Section 13(4) of the Act, the borrower files appeal before DRT under Section 17 of the Act, the matter be contested appropriately. If any application for stay of the further proceedings by the bank under Section 13(4) is made, the same be opposed, having regard to the facts and circumstances. For this purpose, the counsel engaged be briefed thoroughly. If, for any reason, a stay order is likely to be passed by DRT, effective arguments be made so as to enable DRT to pass a conditional order.

C) MATTERS WHERE NOTICE(S) UNDER SECTION 13(2) ARE TO BE ISSUED:

- Action be taken as per procedure detailed in the manual on enforcement of Security Interest.

- If borrower sends reply/objections, the same be considered reasons for not accepting the objections or points raised be communicated to the borrower as per procedure given above.

- If no reply/objections are received, or if the reply/objections received have been considered and responded, further steps under Section 13(4) of the Act be taken as per guidelines given in the manual for Enforcement of Security interest.

- If, upon taking any measures under Section 13(4) of the Act, the borrower files an appeal against the measures taken under section 13(4),the matter be appropriately contested. If application for stay of the proceedings under section 13(4) is moved, the same be opposed

effectively and the counsel be briefed thoroughly for arguing effectively in the matter .If, for any reason a stay order is likely to be passed by DRT, effective arguments be made so as to enable DRT to pass a conditional order.

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Bank of Baroda v. Fairgrowth Financial Service Ltd,

Bank of Bihar Ltd v. Damodar Prasad and another

Bank of England v. Vaglian,

Bank of India v. HCL Ltd,

Bank of India v. U. Rai,

Bank of Maharashtra v. Automotive Engineering Co.

Bank of Maharashtra ltd. v. Official Liquidator,

Bharat Appliances Corporation v. Syndicate bank,

Canara Bank v. Gokuldas Shenoy,

Canara bank v. Sreeram Srinivas,

Central Bank of India v. Indian Light Gauge Metal Products Pvt.Ltd,

Central bank of India v. Parween Nayak,

Central bank of India v. V. Gopinathan,

Corporation Bank v. D.S. Gowda,

Corporation Bank v. Filmalaya Pvt.Ltd,

Dena bank v. K.K.Alex alias Alexander,

Dena Bank v. M.P. National Textiles Corporation Ltd,

Essa Ismal v. Indian bank Ltd,

Evans v. National Provincial Bank of England,

First National Bank v. Devi Dayal,

Foreman v. Bank of England,

Foster v. Bank of London,

Gibbons Singh Hira Singh v. Punjab National bank & another

Gopalkrishna Trading Company v. D. Baskaran,

Gujarat State Financial Corpn,

Haridas Mundra v. National & Grindlays Bank Ltd,

Harprasad & Co. Ltd v. Sudarshan Steel Mills & other

Hindustan Commercial bank Ltd v. Probodh Kumar Mitter,

Hyderabad Commercial v. Indian Bank & others,

Indian Bank v. Cytholic Syrian Bank Ltd.

Indian Bank v. K.Natraja Pillai,

Jagjivandas v. The Nager Central Bank,

Jammu & Kashmir bank Ltd. v. Chandra Prakash,

Japson National v. State bank of India

Jayachandra Kumar v. State Bank of India

Joseph Zachra v. Joseph Kwiakose,

K.T.Shibaiah v. Registrar of Co-operative Societies

Kamal Devi v. Pt. Mani Lal Tewari,

Kanta Mehta v. Union of India and others,

Kattabomman Transport Corporation Ltd v. State bank of Travancore,

Life Insurance Corporation of India v. United Bank of India Ltd,

MSEB v. Official Liquidator,

Mahesh Chandra v. U.P.Financial Corpn.

Muncipal Council v. Sambaiah,

Muthion v.Syndicate Bank,
N. Narayanaswami v. Madan Lal,
Nadar Bank Ltd v. Canera Bank Ltd,
P.M.Dass v. Central bank of India,
Panalal v. Union of India,
Punjab & Sind Bank v. Manpreet Singh Sood,
Punjab National Bank v. Rama Chaudhury,
Punjab National Bank v. Surendra Prasad Sinha,
Punjab National Bank v. Union of India
Rajapati Prasad v. Kaushalya Kuer,
Rogers v. Whitelay,
State bank of Hyderabad v. Susheela and other,
State bank of India v. Depro Food Ltd,
State bank of India v. Indexport Regd,
State bank of India v. Karla Financial Corporation
Syndicate Bank v. Subhas Venkappa Savalkar and other
Syndicate Bank v. Vijay Kumar,
UCO Bank v. Hem Chandra Sarkar,
United bank of India v. Parimal Paramani,
Vijaya bank v. Bhatija,
Vijaya bank Ltd, v. Indian bank,

QUESTIONARE

An elaborate questionare was prepared and addressed to the bankers, lawyers, borrowers and other persons who have academic interest in this topic; in format given below.

1. What way you are interested/concerned with the growth of NPAs?
2. What according to you are the main reasons for creation of NPAs?(Please state 5 reasons)
3. What are the steps the lender can take to safeguard his interest before lending?
4. What are the major criteria for identifying a good borrower?
5. Is the Industry concerned about technical up-gradation of project?
6. What measures do you suggest for identifying a viable project?
7. Are you aware of the project appraisal? If so, what improvements you can suggest for in the existing project appraisal?
8. Do the banks discourage priority sector lending?
9. Do you think that priority sector lending should be minimized?
10. Do you think that the government sponsored programmes as popularity methods shall be minimized?
11. What is your opinion about the social commitment of the banks?

12. Are the bank and the F.ls are serious in follow up effective?

13. What measures you suggest to make the follow up effective?

14. Do you feel that the NPA norms must be made easier?

15. Is it necessary to relax prudential norms to help NBFCs?

16. Is it necessary to give concession to people effected by natural calamities?

17. Is the existing provising norm adequate?

18. Do you prefer charging Interest at PLR or rate a lesser rate for all advances from the Date of NPA?

19. Do you support rescheduling the loans as on the date of NPA?

20. Will early alert system help to minimize NPA?

21. Do you think the existing legal machinery is effective?

22. What is the reason for delay in court proceedings?

23. Do the borrowers prefer cases for getting time and lesser interest rates?

24. Does the one time settlement creates adverse impression on regular repayer?

25. Do you feel the DRT is effective?

26. Do you feel injustice is done to borrowers in DRT by denying oral evidence?

27. Is the Securitisation Act a just law?

28. Does it confer arbitrary powers on the banks?

29. Is there an adjudication of debt in the scheme of the Act?

30. Do you prefer establishment of DRT in every district?

31. What improvements you suggest in the working of DRTs?

32. Do you feel that Securitisation Acts takes away the jurisdiction of courts?

33. Do you feel that there is misuse of provisions of Securitisation Act by banks?

34. Do you feel that effective recovery is possible only in respect of cases where there is mortgagee of immovable property?

35. Do you suggest any improvement in the system of mortgagee and creation security in order to cope of with the new economic order?

THE END